CITE THIS BOOK

THUS:

**first tuesday**

# Legal Aspects of Real Estate

4th Edition

**Cutoff Dates:**
Legal editing of this book was
completed April 2007



**Printed in the United States of America**

***Editorial Staff***

Legal Editor/Publisher:
*Fred Crane*

Managing Editor:
*Ai M. Kelley*

Project Editor:
*Connor P. Wallmark*

Contributing Editors:
*Giang Hoang*
*David F. Crane*

Senior Editorial Assistant:
*Joseph Duong*

Editorial Assistant:
*Sylvia Rodemeyer*

**Comments or suggestions to:**
first tuesday, P.O. Box 20069, Riverside, CA 92516
www.firsttuesday.us

# Table of Contents

*for Online and CD-ROM versions*

## Section H

**Contract Remedies**

# Table of Forms

*for Online and CD-ROM versions*

# Introduction

**Legal Aspects of Real Estate** is part of the **first tuesday** series of California specific real estate study materials. Each title in the series has a different topic as its primary content. As part of a comprehensive real estate education program, the series also includes Principles of Real Estate, Real Estate Practice, Real Estate  Property Management and Real Estate Finance.

**first tuesday's** real estate series uses plain language and eliminates the extensive overlap of identical course material commonly offered by otherpublishers. Issues arising in more than one factual setting are referenced as necessary, but are dealt with fully in only one **first tuesday** title.

**Legal Aspects of Real Estate** is written for California brokers, sales agents, attorneys, title attorneys, title officers, property owners and buyers and sellers of real estate. The course material is designed to be an educational tool for use in the class room and as a current technical research reference.

**Legal Aspects of Real Estate** presents a selection of working examples covering issues pertaining to real property estates, vestings, disputes involving neighboring properties, water rights, and restrictions on property use. Also discussed are property title conditions and insurance, conveyancing, involuntary liens, the enforcement of real estate rights, and remedies for financial recovery in a transaction gone awry. Special emphasis is placed on influential court cases which shape real estate law.

**Legal Aspects of Real Estate** will take the reader far be yond a minimum acceptable level of subject matter awareness and give them a crucial edge in the excit ing and lucrative California real estate industry.

# Chapter 1 — Origins of California real estate law

*This chapter reviews the two primary historical sources of California real estate interests and conveyances.*

## The English and Spanish influence

Historically, California real estate law has been influenced by two key sources of human conduct:

- the English legal system, or *common law*; and
- the Spanish legal system, or *civil law*.

The **common law** of England has been the predominate influence and was officially adopted by California soon after obtaining statehood in 1850. [Calif. Civil Code §22.2]

The **civil law** of Spain, while less influential, has nevertheless left a significant impact on California real estate law.

For example, California's *community property law*, which governs property ownership between husband and wife, is derived solely from Spanish civil law.

Also, many land titles in California are based on Spanish and Mexican land grants, as are water rights.

## Predominant force

The English common law system began with William the Conqueror's Norman invasion of England in 1066.

During that period, England was a fractionalized island since various invaders had established settlements, including the Angles, Saxons, Celts and even the Vikings.

Naturally, these distinctive peoples spoke different languages and settled legal disputes based on their own unique local customs.

William the Conqueror's goal was to create one uniform or **common** language and one **common** law for all of England.

## The "common" law

The entire English common law system was placed in the king's court, called the *Curia Regis*.

Under the common law, legal disputes were decided on a case-by-case basis before a judge. Even today, the common law is often called "judge-made" law.

As the English language became the established language, the legal decisions of importance were written into year books.

When similar legal disputes arose, the judges would refer back to these earlier decisions written in the year books as a basis to decide current cases.

The reliance on an earlier decision to decide a current case is called *stare decisis*. The earlier case relied on is called *precedent*. The decision making process of **stare decisis** is fully applied in California today.

## Common law real estate

In addition to implementing one common language and legal system, William the Conqueror is credited for creating real property law. However, private ownership as it is understood today never existed in feudal England.

Under the feudal system, the King of England was the highest source of the law and all right to the use of land had to be traced to an authorization from the king. Individuals were divided into freemen and nonfreemen, corresponding to the *freehold estates* and *nonfreehold estates* they held in real estate.

Only freemen, who usually obtained their status based on bloodline, could own and hold title to real estate. Today, an owner of a **freehold estate** owns the *fee title* to a parcel of real estate.

Ordinary individuals, called *nonfreemen*, could not own real property. They could only own personal property, called *chattels*. A nonfreeman could only possess and occupy the real estate of another. This is legally called *tenure*, from which the word "tenant" is derived.

In today's law, a **nonfreehold estate** consists of a landlord and tenant relationship. However, these estates are real estate interests, not personal property. [CC §761]

The English common law legal system was brought over to the United States during America's colonial period. To encourage colonization, the King of England granted the right to use land to tenants as long as the land was worked somehow for the crown's benefit, usually agriculture.

After the American Revolution, the United States permitted a tenant to acquire title to the real estate he occupied.

The influence of English common law in California began in earnest when the United States acquired California in 1848 after the Mexican-American War.

## Spanish influence

The influence of the Spanish legal system on California began in 1542 when Juan Cabrillo landed on the beaches of San Diego Bay.

The source of Spain's legal system is traced directly to Roman civil law. **Civil law** attempts to settle legal disputes by establishing elaborate statutes to address the issues in advance of the disputes, rather than on a case-by-case basis.

The only state in the United States which retains a good deal of the civil law today is Louisiana; the source of its civil law is traced back to France.

## Historical ownership

When first discovered, California was called *Alta* (or *"Upper"*) *California*.

Interestingly, the name "California" has its source in a piece of Spanish literature, *Las Sergas de Esplandian*. In the work, "California" is a mysterious island west of the Indies inhabited by giants.

Actual Spanish colonization of **Alta California** did not begin until 1769, over two hundred years after Spanish discovery.

Under the rule of Spain, all of California's real estate belonged to the King of Spain. All real estate obtained through colonization was acquired on behalf of the king. The right to use real estate came from the king's political or military agencies.

To expedite colonization, Spain established four grants of rights in land under its *Law of the Indies*:

- *missions* (religious settlements);
- *presidios* (military settlements);
- *pueblos* (civilian settlements); and
- *ranchos* (private grants).

### The missions

**Missions** were essentially religious outposts for the Catholic Church which were operated by the Franciscans. The King of Spain granted use of the land to the Church to convert natives to Catholicism and assimilate them into the Spanish culture and way of life.

A total of 21 missions were established as settlements in Alta California along what was called *El Camino Real*, or *"The Royal Highway"*. The Catholic Church was permitted to use and occupy the land for the proposed benefit of the Native Americans. As such, the Catholic Church was considered a *trustee* of the land by the King of Spain.

After completing their colonial objectives, the missions were secularized and the land was converted into civilian settlements, called *pueblos*.

The missions did not involve many parishes and they became well established settlements. Their operations, while crude, became profitable, thus prompting the land to be highly desired by Spanish military leaders seeking to acquire private grants of land.

A majority of the missions were established at pre-existing Native American villages, called *rancherias*. Due to their locations, the missions acquired use and control over some of the best farming and grazing land in California. Naturally, once the missions were established and successful, the Catholic Church was reluctant to give up the operations of the missions.

To head off the private acquisition of the real estate surrounding the missions, the Catholic Church staked claims to the use of lands between each mission even if the land was not directly occupied for mission purposes.

Conflict between the Catholic Church and the private landowners ensued. The result was the secularization and removal of the mission operations which began under Spanish rule, but was completed under Mexican control.

The Native Americans were not given any real property rights while the real estate was managed by the missions.

### The presidios

A *presidio* was a military outpost for the Spanish government established to protect the missions and pueblos and to discourage other nations from encroaching on Spain's territory.

Spain established four **presidios** in California, one in each: San Diego, Santa Barbara, Monterey, and San Francisco. The operations of the presidios were run entirely by the Spanish military.

The presidios were far less prosperous than the missions. They were established at strategic military locations without regard for good farming or ranching conditions.

However, like the missions, the presidios became established settlements of agricultural lands, grazing lands and home sites for officers and settlers. In fact, the presidios were recognized as **pueblos** by the United States government when California was acquired as a territory in 1848.

The military commander of each presidio had authority from the King of Spain to convey real estate to occupy and use within a four square *league* area around the presidio for the settlers, retired officers and traders. A **league** was approximately 4,400 acres.

Presidio lands did not prove to be the best for establishing long-term colonial settlements due to poor economic locations. Naturally, the Spanish military began to covet the prime mission land for private grants of land.

The private land grants came from the Spanish King's governor of California, who during the Spanish and Mexican rule was also the supreme military commander.

Thus, members of the military became the primary beneficiaries of the governor's private land grants (**ranchos**) of unused real estate outside the presidios, missions and pueblos.

## The pueblos

A *pueblo* was an established **civilian** community separate from the Catholic Church and Spanish military. The **pueblos** were to become the urban centers in California.

Two of the key pueblos established were Los Angeles and San Jose. The Spanish government induced Spanish settlers to colonize and occupy the lands of California by offering lots of real estate for occupancy within the pueblos.

Similar to a military commander at a presidio, the mayor of a pueblo had the authority to convey four square leagues surrounding the settlement.

Settlers were granted house lots, farm lots or grazing lots by the Spanish government in exchange for improving the lots. Additionally, the settlers were granted tax benefits for working the lands. Profits from the lands were then given to the government as consideration for the conveyances.

The primary purpose of the pueblos was to solidify Spain's control of California by creating long-term communities.

However, without the ability to obtain absolute ownership of real estate, the settlers were not sufficiently motivated to work the lands. Without the motivation of ownership, the pueblos struggled. When the United States acquired California in 1848, the pueblo claims were recognized as being owned by the municipality itself, not by individual lot owners. No fee ownership could be traced to the individual citizens under Spanish or Mexican law.

The United States considered the arrangement of pueblos as Spain holding real estate in trust for the citizens. California acquired the pueblos under this *trust theory*.

Ultimately, the pueblos were given city *charters* by the new State of California. The new municipalities then conveyed fee ownership interests in the lots to the citizens who could prove they had occupied the lots.

### Mexican rule

In 1821, Mexico obtained independence from Spain. After independence was declared, Mexico recognized the Spanish rancho concessions as valid private grants of land.

More importantly, the Mexican government fully secularized the missions and sought to develop the vast, unused mission lands as additional ranchos by issuing land grants.

However, Mexican rule was short-lived as the United States obtained California as a result of the Mexican-American War in 1848 — only one year before gold was struck in California.

### Ranchos

A *rancho* was a private grant of land outside the missions, presidios and the pueblos. **Ranchos** were the beginning of private property ownership under the Spanish rule of California. The owner of a rancho was called a *ranchero*.

Ranchos were reserved for military leaders or heroes, high government officials or the affluent in order to encourage further development of the unused land.

Technically, the owner of a ranchero still did not have absolute ownership, but he had the *right to use and produce* off the land.

Legally, this right to use the land was called an *usufruct*. Today, California water rights are the subject of these **usufruct** rights.

### Rancho grants

Under Spanish and Mexican procedures, a rancho was obtained by a written petition to the Spanish governor, along with a map and approximate legal description of the real estate in question. Legal descriptions were based on identifiable natural monuments such as trees, rocks, bodies of water, etc.

The Spanish governor would send an official to survey the proposed rancho and physically inspect the real estate to verify any other claims to possession.

Once the written petition was approved by the governor, the Spanish/Mexican government would issue a grant subject to the final approval by the provincial legislature.

The original petition, the official's survey report and a copy of the governor's grant were affixed together and stored with the California secretary's office. The grant and collective documents were called an *expediente*.

The original grant was returned to the ranchero for his own records.

### American rule

The Mexican-American War ended with the signing of the Treaty of Guadalupe Hidalgo.

Under the treaty, the United States agreed to acknowledge the existing land grants conveyed by the Spanish and Mexican governments.

The United States set up a *land commission* to document the validity of the land grants. The land commission established land titles and created the chain of title still used for all California real estate today.

After confirmation of a valid land grant, the land was surveyed by the federal government and conveyed to the rightful owner by a United States *patent deed*.

All land not under a valid claim became part of the public domain of the United States.

In 1850, the United States granted part of the unclaimed real estate to the State of California. The balance was retained by the federal government.

While the **land commission** worked in a proficient and fair manner, the United States government was slow to approving many claims. Many rancheros had to wait years, even decades, before receiving a **patent deed** from the United States government.

Survey delays and protracted litigation were the prime culprits for the demise of the last ranchos. Additionally, Spain and Mexico had no recording or land indexing system to perfect and identify title to real estate.

During the appeal time, the real estate was unmarketable since most buyers did not want to take the risk of purchasing real estate with unprotected title.

Many rancheros, faced with financial ruin, sold off to Yankee speculators.

With Yankee speculators buying, or lending and foreclosing on the lands, the Spanish influence on California real estate law came to an abrupt end.

*Editor's note — The primary source for material in this chapter came from the text:* ***Land in California: the story of mission lands, ranchos, squatters, mining claims, railroad grants, landscrip, homesteads.****, by W.W. Robinson, The University of California Press, 1948.*

# Chapter 2 Understanding real estate law

*This chapter presents the powers to regulate real estate given to the state and federal governments under the United States Constitution. Also reviewed are the constitutional guarantees given to real estate owners when the government abuses its powers.*

### The role of the federal Constitution

All real estate law can be traced to a statute or a court decision. Consequently, to understand real estate law, it is essential to understand the source of our statutes and case law which shape current real estate practice.

The United States Constitution is the supreme law of the United States. [United States Constitution, Article VI, clause 2]

All powers which the state and federal governments possess are derived from the United States Constitution.

The United States Constitution enumerates (lists and explains) the powers of the federal government. All other powers not given to the federal government rest with the individual states or **with the people**. [U.S. Const., Amend. X]

The form of government in which individual states share powers with a national or central government is called *federalism*.

**Federalism** is based on the belief that certain legal problems are best handled nationally, while others are best dealt with on the state or local level. The boundary between state and federal rights is ambiguous and in constant flux.

Under federalism, the individual states remain independent (sovereign) and regulate matters within their own borders which are not controlled by the federal government.

In fact, each state has its own constitution similar to the United States Constitution to regulate state matters remaining under their control.

Still, the United States Constitution remains the basis for all rights in the country. However, a state may provide more constitutional protection than the federal government if it chooses, but it cannot provide less.

### Federal and state constitutions

To illustrate the dynamic between the state and federal government, consider the following situation.

An owner operates a shopping center in a state other than California. The owner does not permit any tenant or visitor to distribute leaflets or express any public opinions on the premises unrelated to advertising the businesses located in the mall.

A political group comes onto the mall to obtain signatures to protest a government activity. The tenants of the shopping center complain the political group is driving away business.

The owner orders the political group off the premises. However, the political group believes the shopping center is a **public gathering place** and the owner cannot prohibit the expression of free speech under the United States Constitution.

The owner claims the shopping mall is **private property** and visitors who do not comply with any of the shopping center rules and regulations may be ejected.

Can the owner keep the political group out of his shopping center under the United States Constitution?

Yes! The owner may eject the political group since a shopping center is considered private property under the United States Constitution. [**Lloyd Corp., Ltd.** v. **Tanner** (1972) 407 US 551]

**Freedom of speech** rights provided by the United States Constitution do not extend to private property, unless the private property has been dedicated to the public.

## California's expanded protection

Consider the same political activity, except with the shopping center **located in California**.

Instead of using the United States Constitution, the political group claims the **California Constitution's** freedom of speech clause (essentially identical to the federal clause) permits public protest in a shopping center.

The political group is aware an attack based on the United States Constitution is futile due to existing case law. [Lloyd, *supra*]

Can the political group, under the California Constitution, peacefully obtain signatures to protest a government activity on the premises?

Yes! The political group cannot be removed or prohibited from obtaining signatures in the shopping center. Although private property, the shopping center is open to the public. Owners of purely private property can prohibit political groups from coming onto the premises, but owners of private property open to the public cannot. [**Robins** v. **Pruneyard Shopping Center** (1979) 23 C3d 899]

Thus, these two court decisions appear to be in conflict. However, the two cases are not. California can afford **more constitutional protection** for freedom of speech on private property than the federal government under the United States Constitution does.

The United States Supreme Court recognizes California's right to extend more constitutional protection for free speech. [**Pruneyard Shopping Center** v. **Robins** (1980) 447 US 74]

## Separated powers

Both the federal and state governments created under the United States Constitution are separated into three branches:

- the *legislative* [U.S. Const., Art. I];
- the *executive* [U.S. Const., Art. II]; and
- the *judicial* [U.S. Const., Art. III].

In theory, the **legislative branch** makes the law, the **executive branch** enforces and carries out the law, and the **judicial branch** interprets and settles disputes under the law.

The state and federal **legislatures** enact the *codes and statutes* which regulate some aspects of real estate.

The **executive** polices the law and establishes *regulations* to carry out the administration of government as established by the legislature.

The **judiciary** settles disputes and issues *case opinions* regarding the application of the law and regulations.

No branch may exercise a power given to another branch. However, as will be later illustrated, all three branches of the government actually make law.

This chapter focuses primarily on the legislative branch of the government. The following chapter discusses the function of the judicial branch.

## Authority to legislate

The federal and state legislatures and local governments can only enact laws if they have been given the power to do so by the United States Constitution or the California Constitution. [U.S. Const., Art. I]

The authority of the California legislature to enact laws regulating real estate activities comes from three main constitutional powers:

- the police power;
- the power of eminent domain; and
- the power to tax.

The United States Constitution confers on California the right to enact laws to protect the public health, safety and welfare. [U.S. Const., Amend. X]

The California Constitution confers an equal power to local cities and counties to likewise protect the public good. [California Constitution, Article XI §7]

This power to protect the public well-being is called *police power*. **Police power** is the source of the state or local government's authority to act.

The police power is the basis for laws governing such things as highway construction and maintenance, rent control, zoning and traffic. [**Village of Euclid, Ohio** v. **Ambler Realty Co.** (1926) 272 US 365]

A statute or ordinance passed under the government's constitutional police power and affecting real estate related activity will be valid as long as the law:

- is fair and reasonable;
- reaches a legitimate state interest;
- does not unreasonably burden the flow of interstate commerce; and
- does not conflict with related federal law.

## Eminent domain

The second key power of the state to regulate real estate is the power of *eminent domain*. [Calif. Const., Art. 1 §19]

**Eminent domain** is the right of the government to *take* private property for public use.

However, the government must pay the owner the fair market value of the property taken. [**Loretto** v. **Teleprompter Manhattan CATV Corp.** (1982) 458 US 419]

The process of using the power of eminent domain is called *condemnation*.

Examples of eminent domain include condemning property to provide highways and roads, establish parks, construct flood control levees and provide land for redevelopment.

## Inverse condemnation

The government's exercise of police power may actually become a **taking** of an owner's real estate.

For example, an owner demolishes his beachfront bungalow. The owner intends to rebuild a better home and submits an application to the coastal commission which has been given jurisdiction over the use of beachfront property by the legislature.

A public beach is located nearby, but not directly adjacent to the owner's real estate.

The costal commission wants the owner to grant access to the public beach across his beachfront property to allow people to reach the public beach by walking on the beachfront located on his property.

The costal commission claims its goal is to allow better public viewing of the coastline.

The costal commission grants the owner a permit to build, conditioned on the owner granting to the public a frontage easement across his beachfront property.

The owner refuses the condition unless the costal commission pays for the easement. The costal commission denies the owner's application and permit to build, claiming it is reasonably exercising its police power.

Does the costal commission have to pay for the easement across the owner's beachfront?

Yes! The costal commission has not merely restricted the owner's use of his land, it has required him to deed an interest away in the form of a frontage easement. [**Nollan** v. **California Coastal Commission** (1987) 483 US 825]

Had the costal commission condemned and taken the easement by its power of eminent domain, it would have had to pay for the strip.

Thus, conditioning a permit to build on the granting of an easement to the public is a taking which also requires **reimbursement** to the owner from the governmental agency. In this case, the costal commission could not show the requirement of the easement related to a legitimate state interest.

However, most California inverse condemnation cases filed by owners fail. California courts do not want to burden local governments with the obligation of paying for any diminution of property values which result each time it regulates or downgrades the use of real estate. [**First English Evangelical Lutheran Church of Glendale** v. **County of Los Angeles** (1989) 210 CA3d 1353]

## The power to tax

A crucial power for the state and local government to regulate is the **power to tax** real estate activities to generate revenue to fund state and local governmental functions. [Calif. Const., Art. XIII D §6]

The power to tax is frequently used to fund and implement the goals of the state and local governments under its police power.

For example, a city passes an ordinance which imposes an **inspection fee** on all landlords renting residential properties based on a flat rate per unit, not current property values.

A landlord subject to the ordinance claims the ordinance is unenforceable since the city must have voter approval before adopting an ordinance which would impose a regulatory fee on property.

The city claims the ordinance is enforceable without voter approval since the fee is imposed on a **use** of the property — renting — not on the mere ownership of the property, which would require voter approval.

Here, the ordinance imposing the inspection fee on landlords based on a flat rate is enforceable. Voter approval is only required when fees and taxes are imposed on owners simply because they own real estate. Fees and taxes imposed on the owner's exercise of his uses and rights which come with owning the property do not require voter approval. [**Apartment Association of Los Angeles** v. **City of Los Angeles** (2001) 24 C4th 830]

## Federal authority to regulate

The federal government's authority to regulate real estate also comes from the United States Constitution.

Like the state, the federal government has the power to tax and the power to take private property for public use. [U.S. Const., Amend. XVI; Calif. Const., Art. 1 §19]

However, the federal government has no police power. In its place, the federal government has a very powerful clause to regulate areas of federal concern, called the *commerce clause*.

The federal government has the right to regulate all commercial enterprises which affect **interstate commerce**.

Originally, the clause was designed to combat attempts by local states to pass protectionist laws under their police powers which would inhibit the flow of goods in interstate commerce. [**Gibhons** v. **Ogden** (1824) 22 US 1]

The **commerce clause** was at one time commonly called the *interstate commerce clause*.

Today, the clause also applies to local and intrastate activities which have an indirect effect on the flow of goods, services and people from state to state.

For example, an owner runs a motel located off a state highway occupied by travelers visiting in-state. The motel owner refuses to rent to minorities.

The federal government sues the owner, claiming his conduct violates the federal Civil Rights Act.

The owner claims his motel business is purely local and Congress (the federal legislative branch) has no constitutional authority to regulate his entirely local business.

The federal government claims its authority is derived from the commerce clause and the owner's refusal to rent to minorities inhibits the flow of interstate commerce — which includes the mobility of people.

Does the federal government have the right to regulate local business that may only have a slight impact on interstate commerce?

Yes! The federal government's interest in the flow of commerce between states outweighs the owner's right to exclude minorities. [**Heart of Atlanta Motel, Inc.** v. **United States** (1964) 379 US 241]

The ability of the federal government to regulate a purely local activity even extends to local real estate brokers' activities within their associations.

For example, a broker sues the local association of realtors for federal **antitrust violations**, claiming the association **fixes rates** charged by its members for their services.

The association ostracizes brokers who refuse to comply with the fee-setting policy which are established by the association to maintain a minimum acceptable level of income for real estate professionals.

The association claims its activities are totally local and the federal government cannot regulate the activities as their services are purely local and do not affect interstate commerce.

Do the federal antitrust laws cover local brokerage activities?

Yes! The association's fee-setting of the charges for their members' services affects housing locally, which in turn affects the desire to live in the area, which in turn affects interstate commerce. [**McLain** v. **Real Estate Board of New Orleans, Inc.** (1980) 444 US 232]

*Editor's note — California has its own antitrust laws covering price fixing by California real estate brokers and their associations. Thus, suits could be brought under state or federal law, another example of overlapping applications within the federal system. [Calif. Business and Professions Code §16600;* ***People*** *v.* ***National Association of Realtors*** *(1984) 155 CA3d 578]*

### Federal and state law conflicts

The states have the sovereignty to regulate within their own borders. At the same time, the federal government has the right to regulate local activities affecting commerce.

What happens when federal and state law conflict? Consider the following example.

An airport is established under the Federal Aviation Act of 1953. The airport expands its number of late night and early morning flights. The residents around the airport complain of the noise during late and early hours.

The city where the airport is located passes an ordinance restricting the number of flights between 11 p.m. and 7 a.m.

The airport objects, claiming it was established under the sole jurisdiction of federal law and the Federal Aviation Act of 1953 set forth by the Federal Aviation Administration (FAA) which has no restriction on flights between 11 p.m. and 7 a.m.

Does the federal law *preempt* (supersede) state law?

Yes! The goals of national flight service and the role of the FAA outweigh local laws inhibiting flight times. [**City of Burbank** v. **Lockheed Air Terminal, Inc.** (1973) 411 US 624]

A federal law will **preempt** state and local statutes and ordinances when:

- the federal interests outweigh local interests;
- the federal law is so pervasive as to exclude inconsistent state law; and
- inconsistent treatment nationwide would result if state law controls.

Thus, it is possible for federal and state law to regulate the same real estate activity.

For example, there are federal and state fair housing laws prohibiting discrimination. Both the state and federal governments can regulate **fair housing**. The state may provide more but cannot afford less protection than the federal law. [Calif. Civil Code §51]

**Constitutional guarantees**

The United States Constitution gives owners guarantees when the federal or state government attempts to usurp their powers.

Two key constitutional guarantees exist for real estate owners:

- the *due process clause*; and
- the *equal protection clause*.

Under the **due process clause**, the government must deal fairly with real estate owners.

Even if the owner does not win his case, the courts will oversee that he will be treated fairly by the government.

The due process clause covers both:

- the content of laws, called *substantive due process*; and
- how the government procedurally applies those laws, called *procedural due process*.

For example, a city places a tax on parking lot owners to fund traffic services.

The parking lot owners feel the tax is excessive and an unfair burden on their business. The parking lot owners claim the tax violates the due process clause of the United States Constitution.

The city claims the parking lot tax is a reasonable exercise of its police power.

If the tax itself is unreasonably high and burdensome, it violates the due process clause in the United States Constitution and would be invalid. [**City of Pittsburgh** v. **Alco Parking Corp.** (1974) 417 US 369]

However, if the tax does not overly burden owners, the tax survives a **substantive due process** attack.

## Procedural due process

Procedurally, an owner must be given **notice** of any government action or law and an **opportunity** to be heard on the matter. [**Mullane** v. **Central Hanover Bank & Trust Co.** (1950) 339 US 306]

For example, a city passes a zoning ordinance restricting the extent to which a newsstand can block a city sidewalk. Additionally, the city delegates to itself the authority to seize and close newsstands it feels violate the ordinance.

A newsstand owner's business is closed by the city government without warning to the owner. The city claims it may do so since the ordinance exists.

Does the city's seizure and closing of the owner's newsstand violate the owner's due process rights?

Yes! The city did not provide the newsstand owner with a notice of the violation or an opportunity to be heard before his business was closed. [**Kash Enterprises, Inc.** v. **City of Los Angeles** (1977) 19 C3d 294]

### Equal protection

*Equal protection* laws provide for similarly situated persons to be treated similarly under the law.

For example, a subdivision's covenants, conditions and restrictions (CC&Rs) contain a restriction limiting sales to nonminorities only.

A minority couple seeks to purchase a home, but the CC&R restriction is enforced by the association governing the subdivision.

Does the restriction violate the couple's rights to **equal protection** under the law?

Yes! Enforcement of the restriction would unfairly separate buyers into arbitrary and suspect classifications. [**Shelley** v. **Kraemer** (1948) 334 US 1]

### Judicial decisions

The preceding discussion addressed the legislative authority to enact laws.

However, the other two branches of government (the executive and judicial) also create law. In theory, only the legislative branch can enact laws and no branch of the government may exercise the powers of another.

Every time a judge interprets a statute or a prior case decision, a new **common law** is created by the opinion produced in his decision. It is as if the legislature introduced and passed an amendment into existing law, and the governor signed the amendment into law.

For example, each time the Civil Rights Act is analyzed and applied to the facts of a case before a judge, the opinion is written in light of prior case law *interpreting* the Civil Rights Act.

### Administrative agencies

As general real estate law becomes more specialized, the role of administrative agencies become increasingly important.

Many **administrative agencies** are given the powers of all three branches of the government: legislative, executive and judicial.

For example, consider a rent control board established by a local city council under *rent control ordinances*.

The board is given authority to enact regulations to implement the **rent control ordinance**. This enactment of regulations is a legislative activity.

The board is also given the power to hear disputes between tenants and landlords, and dispense penalties for a landlord's failure to comply with the law. This is a judicial activity.

In this way, the administrative rent control board has the authority to enact regulations (entailing legislative authority) and hear disputes and administer penalties for noncompliance (entailing judicial authority).

A landlord can always go to court to determine whether the board has overstepped its power and gone too far.

The trend with the courts is to continue to give administrative agencies the necessary powers to judge cases involving their own regulations. Thus, the courts themselves are relieved of processing and resolving these disputes.

# Chapter 3 — Understanding the court system

*This chapter contrasts the federal and state court systems, the basic structure of each and the interplay between the two systems.*

### Federal and state

The durability of a market-place society depends largely on the laws it has established for the ownership of property, the enforcement of contracts and the independent operations of courts and their judges to resolve disputes. Without courts, no system of governance can endure.

Thus, two separate and mutually exclusive court systems have been established to hear disputes arising in California: the **state courts** and the **federal courts**.

Whether a legal dispute belongs in the state or federal court system depends on whether the court has *jurisdiction*.

**Jurisdiction** is the power of a court to hear a case and rule on a legal matter. Jurisdiction is granted to a court by the state or federal Constitution, the state legislature or Congress.

Two types of jurisdiction exist within each court system:

- jurisdiction over the **subject matter** of the lawsuit, such as the ownership of real estate; and
- jurisdiction over the **parties** to the lawsuit, such as a buyer and seller.

### State court jurisdiction

The state of California has a three-tiered court system: trial courts, appellate courts and the Supreme Court. The trial court in the California state court system is named the *superior court*. [California Constitution, Article VI §4]

Prior to June 1998, California's trial courts consisted of both municipal and superior courts. The municipal and superior courts were unified in June 1998 as the superior court. Today, all legal disputes, both civil and criminal, are filed in **superior court** unless jurisdiction has been given by statute to a separately established court. [Calif. Const., Art. VI §10]

One superior court exists in the State of California, with courthouses in each county, totaling 58. In practice, each county is referred to as having its own superior court, for example, the San Benito Superior Court.

Within the superior court system, proceedings where the amount in controversy is more than $25,000 are classified as *unlimited civil actions*. [Calif. Code of Civil Procedure §§86, 88]

*Limited civil actions* involve legal disputes of $25,000 or less and dispense some equitable remedies. [CCP §86]

For example, foreclosure of *mechanic's liens* for a dollar amount less than $25,000 may be brought as a limited civil action in superior court. [CCP §86(a)(6)]

Additionally, a limited civil action can *rescind or reform* contracts as long as any money dispute is $25,000 or less, called *equitable remedies*. [CCP §86(a)(3)]

An **equitable remedy** is a **non-money remedy** and is based on issues of fairness. Specific performance of a purchase agreement or an injunction ordering a nuisance to be stopped are examples of equitable remedies.

To better allocate the caseload of the superior court, each superior court contains a *small claims* division. [CCP §116.210]

The **small claims** division of each superior court has jurisdiction over disputes involving $5,000 or less. [CCP §116.220(a)]

Small claims courts are very informal, barring the use of an attorney to represent a party. The court's rules are designed for quick resolutions of minor legal disputes.

The small claims courts have the authority to issue equitable remedies including rescission, restitution, reformation and specific performance. [CCP §116.610]

A superior court limited civil action may be filed in a small claims court if it falls within the small claims jurisdiction. In this event, small claims court rules govern. [CCP §87]

### Venue in the county of the land

Selecting the branch (county) of the superior court which is the proper location to hear a legal dispute depends on *venue*, not jurisdiction.

**Venue** is often confused with *jurisdiction*. **Jurisdiction** is concerned with which **type of court** is empowered to hear the subject matter of a dispute, such as the superior court or the small claims division within it, or whether the case will be heard in state or federal court.

Venue determines the physical **location of the court** which has jurisdiction and is the correct forum to hear the matter. [CCP §§392 et seq.]

In other words, jurisdiction refers to the **power** of a court to decide a case, venue in the state court refers to the **location** of the court by county.

For example, the proper venue for suits involving real estate is in the county where all or part of the real estate is located. [CCP §392(a)(1)]

For contracts, the appropriate venue is where the contract was entered into or is to be performed, or where the defendant resides. [CCP §395(a)(1)]

Most promissory notes indicate where payment is to be made to establish where the contract (the note) is to be performed.

### Federal jurisdiction of limited use

The federal courts are constitutionally established courts of *limited jurisdiction*. [United States Constitution, Article III §2]

Thus, the federal courts are strictly limited in the types of cases they can hear and decide. On the other hand, the state courts are considered courts of *general jurisdiction* as they are not limited to certain types of controversies.

Unless a party suing can show his case belongs in federal court, it must be brought in a state court. [Federal Rule of Civil Procedure 8(a)(1)]

For the purposes of real estate law, a federal court has jurisdiction over two types of cases:

- disputes involving questions of federal law; or
- legal disputes between citizens of different states.

A federal law case is any case arising under the United States Constitution or the laws or treaties of the United States, regardless of the dollar amount of the lawsuit. [28 United States Code §1331]

Thus, a suit under federal antitrust law, federal securities law or federal fair housing law may be brought in federal court without regard for the amount of monetary loss involved.

However, most suits involving federal law do not have to be brought in federal court. The action is permitted in state court.

It is up to the defendant to remove a federal law case to the federal courts if originally brought in a state court, called *removal*.

The federal courts can refuse to hear a case otherwise properly heard in federal court if a legitimate state interest is involved and the federal court believes the state courts should resolve the issue. [**Burford** v. **Sun Oil Co.** (1943) 319 US 315]

For example, a federal court can refuse to hear a case under a federal law claim if the state has an elaborate regulatory scheme covering the issue, such as in water rights. [**National Audubon Society** v. **Department of Water & Power of the City of Los Angeles** (9th Cir. 1988) 858 F2d 1409]

Additionally, the federal court may require the parties to exhaust their state court rights before suing on federal court grounds, such as interfering with lake front views. [**Sinaloa Lake Owners Association** v. **City of Simi Valley** (9th Cir. 1989) 882 F2d 1398]

In some cases, the federal courts have *exclusive jurisdiction*, such as in admiralty, patent law, or bankruptcy cases, which state courts cannot decide.

Some government agencies are granted the authority to create and enforce federal regulations, such as the U.S. Food and Drug Administration (FDA) and U.S. Environmental Protection Agency (EPA). After Congress passes a law, these agencies create *regulations* designed to implement and enforce the new law. General notice of the proposed regulation is published in the Federal Register and interested persons are given the right to challenge the regulation. [5 United States Code §553]

An *Administrative Law Judge* (ALJ) hears the dispute. The ALJ and is granted authority by the Administrative Procedures Act (APA) to regulate the course of the hearing, rule on offers of proof, receive relevant evidence, subpoena witnesses and records, and make or recommend legislation. [5 USC §556(c); 1305]

Once a regulation is implemented, it is published in the Federal Register and the Code of Federal Regulations (CFR).

ALJs also exist on the state level and hear disputes amongst government agencies, such as the California Department of Consumer Affairs, over matters such as environmental protection or labor management relations.

### Interstate citizens have diversity

Legal disputes between citizens of different states can also be brought in federal court as long as the dollar value is $75,000 or more, excluding interest and costs. [28 USC §1332]

These cases are called *diversity of citizenship* cases. **Diversity of citizenship** also applies to suits involving disputes between citizens of the United States and foreigners or foreign nations. [28 USC §1332(a)]

A party filing an action in federal court based on diversity of citizenship must first establish whether the court has jurisdiction to hear the matter. [FRCP Rule 8 (a)(1)]

The theory behind a diversity of citizenship case is to prevent one party from obtaining an unfair "home court advantage" in one state against a party from another state.

### State/federal court strategies

When a federal court accepts a case between citizens of different states it must decide which state law to apply. Ordinarily, the court will apply the state law where the federal court is located. [**Erie R. Co.** v. **Tompkins** (1938) 304 US 64]

However, the court will weigh the interests of each state on the result of the case. The question of which state law applies occasionally determines the success or failure of a case.

Consider an Arizona resident who owns real estate in Arizona. He decides to sell his real estate and believes buyers in California would be interested in his property.

The Arizona seller lists the property with a California broker who is not licensed in Arizona. The seller signs the listing agreement at his residence in Arizona.

The broker locates a buyer in California and prepares an offer to purchase the property. The seller accepts the offer in Arizona and opens an escrow in California.

The broker performs all his brokerage activities related to the transaction in California. The broker does not cooperate with an Arizona broker.

Later, when the purchase agreement can no longer be unilaterally terminated by either party, the buyer and seller collusively agree to cancel the transaction.

The broker demands his fee from the seller for producing a ready, willing and able buyer.

The Arizona seller denies any brokerage fee is owed since the real estate is located in Arizona and the broker does not hold an Arizona real estate broker license and did not cooperate with an Arizona broker.

For the purpose of protecting its residents, Arizona law requires a broker to have an Arizona license to enforce collection of a fee in Arizona courts. For the same reason, California law requires a broker to have a California license to enforce collection of a fee in California courts.

Where is the best place for the broker to sue the seller for his fee?

California! The broker is licensed in California and performed all his brokerage activities in California. The broker's best chance to enforce collection of the brokerage fee is in a California superior court. [**Cochran** v. **Ellsworth** (1954) 126 CA2d 429]

### Legal maneuvers and choice of law

What legal maneuvers could the seller use to avoid paying the brokerage fee based on subject matter jurisdiction of the federal courts?

Procedurally, the Arizona seller must get the case out of the California court system as California will apply California law and award the California broker his fee.

Strategically, the Arizona seller wants the case removed to Arizona to increase the broker's costs of bringing the suit.

However, it is unlikely the case would be properly removed to Arizona as California has a vested interest in the legal result since the broker and escrow are controlled by legislation relating to their conduct, and the transaction was to be performed (escrowed) in California. [**University Financing Consultants, Inc.** v. **Barouche** (1983) 148 CA3d 1165]

Thus, the seller should attempt to remove the case to federal court, if the fee exceeds $75,000, since the suit involves citizens of different states.

However, even if the seller is able to remove the case to federal court, it would not be advantageous for the seller as the federal court would be located in California and would likely apply California law, resulting in the broker receiving his fee.

The seller's next step is to transfer the case from the federal district court in California to a federal district court in Arizona based on *venue*. [28 USC §1404]

If the federal courts have jurisdiction over the dispute, the next question is which federal district court is the proper **venue**.

Naturally, the Arizona seller would claim the Arizona federal district court is most appropriate since:

- the seller is a resident of Arizona;
- the seller signed the listing agreement employing the broker in Arizona; and
- the real estate is located in Arizona.

On the contrary, the broker will claim California is the proper forum since:

- the brokerage activities justifying payment of the fee occurred in California;
- the sale was escrowed in California; and
- the buyer is a Californian.

A federal court judge decides the correct forum to resolve the dispute. [**Consul Limited** v. **Solide Enterprises, Inc.** (9th Cir. 1986) 802 F2d 1143]

However, one final issue remains no matter which court, state or federal, hears the dispute: which state law applies, Arizona or California?

Naturally, the Arizona seller wants Arizona law to apply. No brokerage fee is owed under Arizona law unless the California broker is also licensed in Arizona or worked on the transaction in cooperation with an Arizona broker.

If the state law to be applied is not agreed to in the listing agreement, then the state law applied will be based on the state with the greater interest in the result.

Brokers with interstate practices eliminate this uncertainty by inserting a California *choice-of-law* clause in the listing agreement. With a **choice-of-law** clause, the parties agree in advance which state's law will apply if a dispute arises. Had the California broker entered into a listing agreement calling for Arizona law to apply, he would have been agreeing the fee provisions in his listing agreement were unenforceable. [See **first tuesday** Form 102 §4.7]

**Jurisdiction over a person's fate**

In addition to subject matter jurisdiction, a court must have jurisdiction over the person being sued, called *personal jurisdiction*. [CCP §410.10]

For *constitutional due process* purposes, a person being sued in California must have at least *minimum contacts* with the state. [**International Shoe Co.** v. **State of Washington, Office of Unemployment Compensation and Placement** (1945) 326 US 310]

California has interpreted **minimum contacts** to include:

- residence in the state;
- a legal appearance to defend the legal action [**RCA Corporation** v. **Superior Court of City and County of San Francisco** (1975) 47 CA3d 1007];
- doing business in the state [**McGee** v. **International Life Insurance Company** (1957) 355 US 220];
- torts committed within the state;
- torts committed outside the state which directly affect activities inside the state [**Buckeye Boiler Company** v. **Superior Court of Los Angeles County** (1969) 71 C2d 893];
- contracts entered into, negotiated or to be performed in the state [**Beirut Universal Bank S.A.L.** v. **Superior Court for County of Los Angeles** (1969) 268 CA2d 832];
- ownership or use of real estate within the state; or
- availing oneself of the benefits of California laws. [**Quattrone** v. **Superior Court for County of Los Angeles** (1975) 44 CA3d 296]

The **long-arm** of California's **personal jurisdiction law** tends to extend quite far, long enough to haul out-of-state or out-of-country defendants into the state to defend themselves.

The out-of-state or out-of-county defendant must receive proper service of process (notice of the lawsuit) to implement personal jurisdiction. [CCP §§413.10 et seq.]

## Trial and appellate courts

Both the federal and the California courts have a three-tiered system: trial courts, appellate courts and one Supreme Court.

As previously discussed, the principal trial court in California is the superior court, with its jurisdiction divided between *limited* and *unlimited civil cases* as well as a *small claims* court division.

The main trial court in the federal system is called the *district court*.

Other trial courts exist in the federal system to hear claims in particular areas of law, such as the:

- United States Bankruptcy Court;
- United States Tax Court; and
- United States Claims Court.

The principal task of the federal trial courts is to decide what are the facts of a case and apply the proper rules of law to resolve the dispute.

A lawsuit is filed then evidence is presented and testimony is given at trial. The facts of the case are determined by the trial court judge (or jury) after everyone has presented their case.

The trial court applies the relevant rules of law to the facts it has determined to exist, and a judgment is handed down as the judge's decision in the case.

In the state courts, the trial court opinions are not published. However, a limited number of opinions in federal trial court cases are published.

The losing party on the trial court level can appeal the judgment to the appellate court.

The appellate court has the authority to review whether the trial court:

- used the appropriate law to decide the case; and
- properly applied the law.

Determining the facts of a case when the evidence is in dispute is the exclusive domain of the trial court. Thus, the appellate court does not have the authority to decide which facts to believe as long as some substantial evidence exists to support the facts.

The appellate court selects which opinions are published to become the basis of future trial court decisions.

### Supreme Court petitions over errors

The final court for appeals in both the state and federal court systems is the *Supreme Court* of each.

With the exception of certain criminal law cases and procedural cases, the **Supreme Court's** review of most appellate decisions is entirely discretionary.

The losing party before an appellate court may *petition* the Supreme Court by asking the court to review the appellate court decision for its correctness.

The **petition** is accepted or rejected by the United States Supreme Court or California Supreme Court.

If the case is accepted, the court is said to grant *certiorari* to review the case.

Only a very small percentage of the cases appealed to the Supreme Courts are ever accepted and heard.

As a result, the opinions of the appellate courts most often become the final statement of the law.

Supreme Court decisions are also published and become the highest statement on the law, to be followed by all of the lower courts within their jurisdiction.

# Chapter 4 — Judicial and political systems in action

*This chapter reviews the constitutional and real estate principles employed to expand mortgage law and diminish ownership rights during the 1980s by use of the judicial and political systems.*

## Toying with rights

To understand the inter-relationships of the federal and state court systems, and the three branches of each of these governments, several evolution-of-law scenarios must be considered.

For example, in 1975, a buyer with the help of his real estate broker locates a single family residence (SFR) to occupy as his home. The buyer wants to acquire the real estate by taking over the seller's advantageous, low-interest 30-year loan.

The buyer makes an offer to take over payments on the seller's existing loan. The buyer will take title *subject to* the lender's trust deed. However, a **due-on clause** exists in the lender's trust deed, also called an *alienation clause*.

On the transfer of ownership to the buyer, the lender calls the loan. The lender claims the due-on clause gives it the legal opportunity when the owner transfers the property to either:

- adjust its loan **portfolio yield** upward to current market levels; or
- call the loan.

The lender notifies the buyer he is qualified to assume the loan, but only on the condition the **loan is modified** — recast to reflect current market interest rates — which is exactly what the buyer is trying to avoid by taking over the seller's advantageous loan.

Thus, the stage is set for a legal dispute between the buyer and the lender — their goals and objectives being mutually irreconcilable:

- the buyer wants to purchase the real estate subject to the seller's existing loan without the lender interfering with his purchase; and
- the lender wants to increase its portfolio yield by recasting the loan to the current, higher interest rates on the purchase.

Unable to exact its demands for a loan assumption when the buyer becomes the owner of the property, the lender calls the loan. The buyer refuses to pay the loan in full and foreclosure is commenced.

## Codified common law to the rescue

For relief from lender interference, the buyer engages the primary source of California's **real estate law** — the *common law*. **Common law**, as adopted by California in the 1872 codes, prohibits any **unreasonable interference** with the transfer of a real estate interest, a legal rule called *conditions restraining alienation.* [Calif. Civil Code §711]

The buyer, based on California's codified common law, claims the lender is **unreasonably interfering** with his purchase and ownership of the real estate.

The lender claims **contract law** principles control, not real estate law, since trust deed provisions permit the lender to call the loan due on any sale.

The California Supreme Court holds the lender must permit the buyer to assume the existing loan, unless the buyer is *uncreditworthy* or poses an unnecessary risk of *impairment* to the real estate, such as would an insolvent arsonist. California real estate law, which pre-existed the trust deed agreement, prohibits enforcement of the terms of any agreement which unreasonably interfere with an owner's right to sell, buy, lease or encumber real estate. [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943]

The rationale for the rule against **conditions restraining alienation** is to keep unfettered and commercially available interests in real estate which have value in the marketplace — a foremost concern to buyers, sellers and brokers.

*Wellenkamp*, with its facts of an institutional lender holding a first trust deed on a single family, owner-occupied property, was next applied to a private lender's second trust deed loan on income-producing real estate.

As a result, the same due-on rule applies to all types of real estate interests, all types of lenders and all interests which have priority to the ownership. [**Dawn Investment Co., Inc.** v. **Superior Court of Los Angeles County** (1982) 30 C3d 695]

However, for lenders operating in California, the legal battle over interferences with the transfer of ownership interests in real estate did not end with the California courts.

## Federal law interplay

Lenders in California were then faced with a dilemma: how could they avoid California's due-on rules prohibiting the adjustment of portfolio yields by recasting fixed rate loans and payment schedules on the sale of the secured real estate, and still make loans in California? Politically, an important fact to remember is nearly 30% of all mortgage funds lent in the United States are lent in California.

The lenders' solution to the due-on problem was to attack the seller's sale by applying **federal** law, since a federal law covering the same legal issue supersedes state law to the contrary, called *preemption*. [United States Constitution, Article VI, clause 2]

Now consider the same facts as our previous example, except the lender is a federally chartered savings and loan (S&L), now called a *thrift*.

In 1976, what is now the Office of Thrift Supervision, a federal agency under which federally chartered thrifts operate, adopted a regulation permitting federally chartered S&Ls to automatically accelerate a loan based on the sale of the secured real estate.

The owner transfers the property subject to the federal S&L loan after the federal regulation is adopted and the lender calls the loan.

The legal dispute is heard in a California appellate court. The court holds the federal regulation does not supersede state law since the regulation requires the S&L to follow state real estate law which preserves the lender's security in the real estate. [**de la Cuesta** v. **Fidelity Federal Savings and Loan Association** (1981) 121 CA3d 328]

Meanwhile, other federal S&Ls attempted to fight the battle in federal courts. From the S&Ls' point of view, the federal courts will prevent the application of the paramount California ownership law since the dispute would be decided on the federal S&Ls' "home court."

However, the federal appellate court refuses to hear the cases, sending the due-on disputes back to the state court system, called a *removal*, citing the legitimate state law interest involved. [**Nalore** v. **San Diego Federal Savings and Loan Association** (9th Cir. 1981) 663 F2d 841]

Under California's state law analysis, the federal S&Ls were required to comply with California's due-on rules like all other lenders. A further appeal by the federal S&Ls was made. The United States Supreme Court accepted the federal S&Ls' appeal for relief. [de la Cuesta, *supra*]

The legal drama was reaching its climax after four years (1978 to 1982) of decisions adverse to lenders under California state law.

As a result, the United States Supreme court held federal S&Ls could enforce their due-on-sale clauses — even if the buyer is creditworthy and poses no risk to the lender's security interest in the real estate. The 1976 federal mortgage regulation was declared to supersede conflicting state rights under real estate ownership laws. [**Fidelity Federal Savings and Loan Association** v. **de la Cuesta** (1982) 458 US 141]

Legally, this federal S&L decision left the remaining financial world in an uproar. All other lenders, including state S&Ls, banks and private lenders could not unreasonably enforce the due-on-sale clause under state law by calling a loan while the federal S&Ls could under federal law (which depressed the rates charged by federal S&Ls).

The state S&Ls, private lenders and banks had no federal regulation to rely on to preempt the state law due-on application designed to protect ownership, unless the transfer impaired their security.

### The solution for all lenders

In response, lenders induced Congress — the legislative branch of the federal government — to enact a federal law which would apply to all types of real estate lenders, permitting them to retroactively enforce the due-on-sale clause since the federally chartered S&Ls now could.

As a result, Congress enacted laws establishing a level playing field for all lenders on all types of real estate and mobilehomes based on the rights of federal S&Ls, not state's rights, called the *Garn St. Germain Federal Depository Institutions Act of 1982* (Garn Act). [12 United States Code §1701j-3]

Congress then delegated its authority to the Federal Home Loan Bank Board (FHLBB) to enact regulations to implement the *Garn Act* controlling the due-on conduct of all private and institutional real estate lenders. [12 Code of Federal Regulations §591]

### The legal cycle was complete

All lenders on California real estate with a due-on-sale clause in their trust deeds could now enforce the due-on clause without regard to state law or to the creditworthiness of the buyer.

In little more than four years following 1978 (plus a restrictive three-year phase-out, phase-in period) there was a complete turnaround in the law. The lender's power brokers (lobbyists) in the halls of Congress had the last word, not real estate brokers.

Thus, an owner who sold his real estate in 1978 subject to a trust deed with a due-on-sale clause (held by a non-federal S&L) could avoid the lender's interference with his sale to a legitimate buyer.

However, if the same owner elected to wait until 1983 to sell the same real estate subject to the same trust deed, he was exposed to the lender's interference with his sale. This change in the law resulted in a shift in wealth, from equity in real estate to interest payments on loans. As a result, homeownership slumped for the next 20 years.

### State legislative changes

The *political exploitation* by lenders and owners of the three branches of government is equally relevant for California state law issues.

For example, in 1982, a tenant in a commercial complex wants to sell his business opportunity.

The rental rate under the tenant's long-term lease is far below current market rates. The landlord failed to anticipate the inflation of future operating costs and local market demands when negotiating rent provisions in his lease agreement with the tenant.

The lease permits a transfer of the tenant's interest in the lease, but only with the landlord's prior consent. Further, the business opportunity buyer has good credit and a strong financial statement and operating history.

The landlord wants to block the transfer and bring in a new tenant at market rates, or permit the proposed transfer on an adjustment of the rent to current market rates. Thus, the landlord refuses to consent to the transfer.

The tenant claims the landlord's refusal to consent is an **unreasonable restraint on alienation**, which is an application of the *Wellenkamp* doctrine to the transfer of other types of ownership interests (leasehold estates) in real estate besides the fee. A leasehold assignment, like a sale and conveyance of the fee, is a transfer of an interest in real estate. [CC §761]

The California Supreme Court held a landlord could not block the sale and transfer of the tenant's leasehold interest unless the landlord has a **commercially justifiable reason** — the same rationale used to block lender interference on sales of fee interests in real estate. [**Kendall** v. **Ernest Pestana, Inc.** (1985) 40 C3d 488]

California landlords could not contractually limit the transfer of nonresidential leases by the tenant. The market place for the sale and assignment of real estate leasehold interest remained open and unfettered by interferences by landlords and lenders.

### The landlord's solution to shift wealth

Lobbyists induced the passage of state legislation to eliminate the *Kendall* decision and allow landlords to interfere with leasehold assignments for economic gain. The legislation shifted wealth from tenants to landlords by reducing the value of the business opportunity and increasing the rent paid to the landlord.

Landlords, like lenders, sought and obtained special legislation to reach their economic objectives – to shift wealth their way as a change in any civil law is meant to do.

Now, by contracting for a clause prohibiting an assignment of the lease or subletting of the premises, landlords can arbitrarily refuse consent or totally prohibit the transfer of the tenant's interest in a lease. [CC §§1995.210 et seq.]

### Real estate dynamics in a democracy

This review of lender interference is not to be interpreted as an indictment or criticism of the legal and political systems real estate owners and brokers operate under. Rather, this review is intended to illustrate how legal and political systems function.

Legal and political decisions about real estate are not made in a vacuum — state residents are affected. As a result of legal and political decisions, the law is not static. Thus, the law of real estate is driven by economic forces and forged by the political process.

The dynamic and ever changing nature of mortgage and real estate law is often taken captive by the desire to shift wealth and change opportunities. The result for real estate brokers is a destabilizing constriction in the resale of real estate and volatility in real estate market values when interest rates rise.

These past judicial and political events, as well as the processes through which our legal and political system works, provide an insight into the real estate laws of the future. These deep-rooted and conflicting lender-ownership issues, like a pendulum, return to be readdressed and altered again and again, subject to the political and economic winds of the time.

# Chapter 5 — How to read and use legal cites

*This chapter reviews the use of code and case indexes as tools for further research and study, as well as the use of legal citations to locate the law applied to a particular real estate activity.*

## Fundamentals underpinning real estate activities

Every aspect of real estate conduct is influenced, if not fully controlled by, a case, statute or regulation called a *citation*, or *cite* for short. **Citations** refer to California and federal laws and are classified by cases, statutes and regulations. Judicially, the relevant citations are applied to the facts in dispute before the court.

To obtain the maximum benefit from this study material, the reader must understand:

- the purpose for our use of cites;
- the location in this study material of other writings based on the cites;
- where to obtain copies of the cites; and
- how to apply these **case rulings**, **statutes** and **regulations** to daily real estate activities.

Prudent readers truly interested in real estate should know how to locate copies and read the important cases, statutes and regulations which affect their real estate business and holdings.

The primary study purpose for our use of citations is to provide the reader with a **legal reference** for the point of law reviewed. By obtaining and reading a copy of the cited material, the reader can acquire more information and background about the subject matter.

Case and code indexes located in the back of this study material are useful tools in the search for additional information provided in this study material. Also, if the reader is using the included Course Materials CD to view the study materials, the search feature provides an efficient method for locating topics and their related cites. Instructions for the use of the search feature are contained in the CD on the "How to Use the Course Materials CD" page.

For example, before meeting with a client, an attorney, or an accountant to review the best handling for a real estate activity, the reader might look up the topic in our topical index or use the CD search feature, then turn or scroll to the referenced page and read about it. The reader should then note any cases or codes which cover the activity to be reviewed.

Next, the reader may locate more information about the case or code he made note of by looking up the cite in our case or code index. Listed with the cite are page numbers of related writings. Our other writings can then be read to confirm, expand or correct the reader's understanding.

Then, the reader can bring these cites to the attention of the client, attorney or accountant to demonstrate the reader's concern — along with a copy of the chapter or related writings if appropriate.

When a chapter covers a point of greater interest to the reader, the reader might obtain a copy of the cites which are intriguing and study them. Such a review will help the reader to better understand and appreciate the development and application of the rules under which owners, lenders, landlords, tenants,

investors and brokers operate. Case opinions, written by the judges who decide a case, are rich in the history and evolution of real estate law and are invaluable educational tools.

### The citation of statutes

California **statutes**, often called *codes* or *legislation*, are categorized and printed in volumes by topic. The topics of categorized codes range from Business and Professions to Welfare and Institutions. All state legislation governing activities in the State of California are contained in these volumes, as are regulations issued by governmental agencies such as the Department of Real Estate (DRE).

Statutes from the Civil Code, a code dealing extensively with **real estate law**, are frequently cited in this study material. For example, [Calif. Civil Code §2349] denotes the code book to pull (California Civil Code) and the section to reference (2349).

On our first code reference in a chapter, the word "Calif." is placed in front of the code name and section. Further references to the code drop the "Calif." and abbreviate the code name. Thus, [Calif. Civil Code §2349] is further cited in the same chapter as [CC §2349].

### The citation of regulations

Also cited in this study material are *regulations* created under statutory authority given to administrative agencies of the state government, such as the Department of Real Estate (DRE). For example, a DRE regulation is cited: [DRE Reg. §2972(f)].

This cite denotes:

- the Department of Real Estate (DRE);
- regulation (Reg.);
- regulation number (2972); and
- one subsection (f).

California **regulations** are published within the California Code of Regulations, formally called the California Administrative Codes, and cited in this way: [10 Calif. Code of Regulations §2972(f)]. This code cite parallels the DRE regulation cite structure analyzed above. However, the number at the beginning of the cite (10) is the "title" or "volume" of California Codes in which the regulation is located.

The organization of federal codes is similar to that of California codes, i.e., with volumes for each category of legal topics. The volume is noted first and the section number last, such as: [42 USC §1125].

However, **federal statutes** are usually cited by their more specific names, such as the Internal Revenue Code. For example: [IRC §469(e)(1)] denotes Internal Revenue Code (IRC), the section number (469) and the subsections (e)(1).

Regulations created by federal administrative agencies are also cited in this study material in this manner: [42 Code of Federal Regulations §1442]. Abbreviated, the cite becomes: [42 CFR §1442].

Frequently used regulations are cited by their familiar names, such as the Treasury Regulations under the Internal Revenue Code. The regulations of the Internal Revenue Service (IRS) contain direct references to the code section they relate to.

The words **et seq.** after a code citation indicate the reader researching the cite must consider the entire chapter in which the code is located, starting with the code section listed.

## The citation of cases

California court **cases** are cited according to the court level which heard the case. For example, the California Supreme Court case of [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943] is broken down like this:

- the name of the case (**Wellenkamp** v. **Bank of America**);
- the year it was decided (1978);
- the volume it is published in (21);
- which court gave the ruling (C);
- the series of published volumes (3d); and
- the beginning page of the case in the volume (943).

A California appellate court cite is basically the same: [**Winnett** v. **Roberts** (1986) 179 CA3d 909]. In this example, "CA" indicates the California Court of Appeal.

Federal case citations follow the same format as the state citation system, with "US" indicating United States Supreme Court cases, "F" for federal appellate court cases, and "F. Supp." for Federal District Court opinions.

For example: [**Fidelity Fed. S&L Assn.** v. **de la Cuesta** (1982) 458 US 141] denotes a United States Supreme Court decision.

Federal citations usually indicate the circuit of the appellate court which heard the case. There are eleven circuits in the United States and California is in the Ninth Circuit. For example: [**Simon** v. **United States** (9th Cir. 1985) 756 F2d 696]

A tax court case is cited in this way: [**The Shaker Blvd. Co.** v. **Simon** (1961) 36 TC 198]. This indicates the case name, the date it was decided, the published volume where the case is found, that it is a tax court (TC) decision, and the page number where it can be located.

On the first reference to a case in a chapter, the full citation is printed. Further references will list only the name of the first party (the plaintiff) followed by the word *supra*. Thus, the citation [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943] on the second reference within a chapter is abbreviated as [Wellenkamp, *supra*].

## Use of case, code and regulation indexes

To look up a code or regulation in our **code index**, the reader must understand how the code index is organized. The code index contains separate sections for state and federal codes and regulations. The codes are further divided into topics and listed alphabetically (i.e. Business and Professions, Civil, Code of Federal Regulations, United States Constitution) with the code sections being listed numerically. To the right of the code section will be the page(s) in the study material where more information about the code may be found.

For a reader to find more information related to a cite in a chapter, the reader would turn to the appropriate code index, locate the code topic and section then turn to the noted page.

### Locating copies of citations

Copies of case and code cites can be obtained in multiple ways, such as:

- law libraries;
- attorneys; and
- the Legislative Bill Room or a legislator.

Additionally, case cites can be obtained online by subscribing to such services as *Shepard's*, available through *LexusNexus*®, or *FindLa*w®. California codes can be accessed online on the official website for California legislative information, *www.leginfo.ca.gov*.

An opinion of a case published in a bound volume contains two sections. The first is merely a publisher's commentary of the case facts and law applied. These comments should be considered only as secondary information.

The second section is the court's opinion and decision, which is the reader's **primary source** of information. The opinion is the court's interpretation and application of the law controlling the dispute before it.

# Chapter 6 — The real estate exists

*This chapter discusses the physical aspects of real estate, the many legal interests which can be held in real estate, and the use of real estate interests.*

## Physical and legal aspects

For a majority of people, the term *property* means a physical or tangible **thing**; something which is owned, such as land, a car or a share certificate. However, **property** is more broadly defined, focusing on the *rights* which arise out of the object. Thus, property is sometimes referred to as a **bundle of rights** in a thing, which for the purposes of this material is specifically real estate.

Additionally, **property** is anything which can be owned. In turn, *ownership* is the **right to possess** the property owned and use it to exclude others from entry. [Calif. Civil Code §654]

The **right to possess** and use property includes the right to:

- occupy;
- sell or dispose;
- encumber; or
- lease the property.

Next, the **types of property** are divided into two primary categories:

- real estate, sometimes called *real property* or *realty*; and
- personal property, sometimes called *personalty*. [CC §657]

Real estate, or real property, is characterized as **immovable**, whereas personal property is **movable**. [CC §§655, 658]

Personal property is defined, by way of exclusion, as all property which is not classified as real estate. [CC §§658, 663]

In fact, personal property was once called *chattel*, a word derived from the word "cattle", cattle being a movable thing.

While the distinction between real estate and personal property seems apparent at first glance, the difference is not always so clear.

## Cutting up the real estate

Real estate can be physically cut up by *severance* of a part of the earth (i.e., removal of minerals). *Title* to real estate can also be cut up in terms of time, providing *sequential ownership*.

For example, fee ownership can be conveyed to one person for life, and on their death, transferred by the fee owner to another. Time sharing is another example of the allocation of ownership by time, such as the exclusive right to occupy a space for three weeks during the year.

**Title** to real estate can also be *fractionalized* by concurrently vesting title in the name of co-owners, such as tenants in common who each hold an undivided (fractional) ownership interest in the real estate.

*Possession* to real estate can be cut out of the fee ownership for a period of time. For instance, the fee owner of real estate acting as a landlord conveys possession of the property to a tenant under a lease agreement for the term of the lease, called a *leasehold estate* or, simply, a *lease*. When the tenancy expires or is terminated, possession of the property will *revert* to the landlord. The landlord retains fee title to the real estate at all times.

**Possession** can also be cut up by creating *divided interests* in a property, as opposed to undivided interests. For example, an owner can lease a portion of his property to a tenant. The tenant, in turn, can sublease a portion of his space to yet another person. Another example of *divided interests* is the co-ownership of a property which gives each co-owner the exclusive use of a specific portion of the real estate they jointly own.

Other interests in real estate can be created, such as *liens*. **Liens** are interests in real estate which secure payment or performance of a debt or other monetary obligation. A trust deed loan or a local property tax are examples of liens. On nonpayment of a lien amount, the lienholder can force the sale of the real estate to pay off and satisfy the lien.

Thus, an owner's rights in a parcel of real estate extend beyond the mere physical aspects of the land, airspace and improvements located within the legally described boundaries of the property.

## Real estate components

Consider a real estate lender who is concerned about the interest he will hold in a parcel of real estate as security for his loan, such as is provided by a trust deed lien on the entire fee, the fee subject to outstanding leaseholds, or a lien on only the tenant's leasehold interest.

Also, consider a tenant who makes improvements or adds fixtures to his leased premises who is concerned about whether he may or must remove the additions on termination of his tenancy, or whether they must remain as part of the real estate.

The **physical components** of real estate include:

- the land;
- anything affixed to the land;
- anything appurtenant (incidental rights in adjoining property) to the land; and
- anything which cannot be removed from the land by law. [CC §658]

**Real estate** includes buildings, fences, trees, watercourses and easements within a parcel's horizontal and vertical boundaries. Anything below the surface, such as water and minerals, or above the surface in the air space, such as crops and timber, is part of the real estate.

For example, the rental of a boat slip includes the water and the land below it, both of which comprise the total of the rented real estate. Thus, landlord/tenant law controls the rental of the slip. [**Smith** v. **Municipal Court** (1988) 202 CA3d 685]

In the case of a condominium unit, the air space enclosed within the walls is the real estate. The structure itself, land and air space outside the unit are the property of the association or all the owners of the separate parcels of air space within the condominium project, creating what is called a *common interest development (CID)*. [CC §1351(f)]

A parcel of real estate is located by circumscribing its *legal description* on the face of the earth. Using the property's legal description, a surveyor locates and sets the corners and *horizontal boundaries* of the parcel.

The **legal** and **horizontal boundary** description of the real estate is contained in deeds, the public records of the county in which the parcel is located, subdivision maps or government surveys relating to the property.

However, real estate is three dimensional and reaches perpendicular to the horizontal boundary. In addition to the surface area between boundaries, the classic definition of real estate consists of the soil below to the core of the earth as well as the air space above to infinity. All permanent structures, crops and timber within this *inverse pyramid* are also a part of the parcel of real estate. The three dimensional aspect of real estate has its source in the English common law. [CC §659]

However, in the modern world, the common law definition of real estate has been radically altered to conform to the changing demands of society.

## Land

The first component of real estate is *land*. **Land** includes:

- soil;
- rocks;
- other materials of the earth; and
- the reasonable airspace above the earth. [CC §659]

The soil and solid materials, such as ores and minerals, are considered land while they remain undisturbed as a part of the earth.

For example, unmined gold dormant in the earth is real estate.

However, when the gold is mined and removed from its surrounding rock, it becomes personal property since it is no longer embedded in the earth. The gold has been converted from something relatively immovable — part of the rock below the soil — to something movable.

Minerals in the soil are *severable* from the earth. Also, fee ownership to the soil and minerals can be conveyed away from the ownership of the remainder of the land.

When ownership to minerals in a parcel of land is transferred, the transfer establishes two fee owners of the real estate located within the legal description — an owner of the surface rights and an owner of the mineral rights beneath the surface. They are not co-owners of the real estate, but are owners of separate vertically located portions of the same real estate.

Both fee owners are entitled to reasonable use and access to their ownership interest in the real estate.

For example, an owner sells and conveys the ownership right to extract minerals to a buyer. On conveyance, there now exists a surface owner and a mineral rights owner.

Later, the surface owner conveys the real estate to a developer. The developer subdivides the parcel of real estate and plans to construct homes on the lots.

The mineral rights owner objects to the construction, claiming the homes, if built, would completely interfere with his right to enter the property and remove his minerals.

Is the mineral rights owner entitled to enter the property to remove the minerals?

Yes! But only as is reasonably necessary to use his mineral rights. The rights of the surface owner and the mineral rights owner are balanced to determine the precise surface location to be used to extract the minerals. [**Callahan** v. **Martin** (1935) 3 C2d 110]

The right to enter the property to remove minerals exists even if the documents conveying the mineral rights fail to provide for the right of entry. [**Wall** v. **Shell Oil Company** (1962) 209 CA2d 504]

The right to remove minerals from another's real estate is called a *profit a prendre.*

### Oil and gas

Unlike solid minerals which are stationary, oil and gas are mobile. Legally, oil and gas are referred to as being *fugacious matter*, since they are transitory.

Oil and gas are perpetually escaping and percolating under the earth's surface. Due to their fleeting nature, a real estate owner does not hold title to the physical oil and gas situated under the surface of his real estate.

At any given time, a real estate owner will have more or less oil or gas depending on gravity and the earth's movements. The ownership interest in the oil and gas unremoved is legally referred to as a *corporeal hereditament*.

In California, oil and gas are incapable of being owned until they are actually possessed — that is, when they have been removed, thus becoming personal property. [Callahan, *supra*]

A fee owner has the exclusive **right to drill** for oil and gas on his premises, unless that right has been conveyed away to others.

Rather than owning the physical oil and gas, the fee owner has a right, called an *incorporeal hereditament*, to remove the oil or gas for his own purposes. [**Gerhard** v. **Stephens** (1968) 68 C2d 864]

Frequently, the right to remove minerals, including oil and gas, is conveyed by sale or lease to another in consideration for the payment of royalties on excavation.

### Removing oil and gas

An owner of land has the right to extract all the oil and gas brought up from his real estate even if taken from an underground pool which extends into an adjoining owners' real estate. [**Alphonzo E. Bell Corporation** v. **Bell View Oil Syndicate** (1938) 24 CA2d 587]

Oil and gas, being *fugacious*, move in and out of the below surface portion of a parcel of real estate. However, an owner cannot slant drill onto another's property to reclaim the oil or gas that has flowed from his property. [Alphonzo E. Bell Corporation, *supra*]

Slant drilling is a trespass on the adjoining landowner's real estate. The trespasser is responsible to account for profits derived from the slant drilling. [Calif. Code of Civil Procedure §349¾]

## Airspace

Land also includes the airspace above the surface of a property. Under traditional English common law, the right to airspace continued to infinity. However, modern technological advances have altered the legal view on airspace.

For example, an owner runs a farm near a military airport. Planes frequently fly over the owner's real estate on their ascent from or descent to the airport.

The government decides to expand the military base by extending the runway and using more advanced (and louder) aircraft at the base. The aircraft, on their approach to the airport, now fly directly over the farmer's barn, scaring the animals and causing the farmer financial loss.

The farmer sues the government for trespass on his real estate since the airspace is being occupied by others — the military.

Can the owner keep the aircraft from flying into his real estate?

No! The common law doctrine regarding the ownership of airspace to the edge of the universe is obsolete. The owner only owns the airspace necessary to allow him a reasonable use of his real estate. The farm owner's real estate extends only so far above the surface of the earth as can be reasonably occupied or used in connection with the land. [**United States** v. **Causby** (1946) 328 US 256]

In fact, the United States Congress has declared the airspace above a landowner's real estate to be a public highway for the navigation of airplanes, helicopters, satellites and spacecraft. [49 United States Code §40110]

However, when the flight of airborne vehicles intrudes upon an owner's use and enjoyment of his real estate below, the intrusive entry may constitute a *taking* of the real estate. The continued noise and disturbance of low-flying aircraft which impairs the enjoyment or value of land by causing disruption has effectively **taken** something from the owner. Thus, the owner must be compensated for his loss. [Causby, *supra*]

## Other blue sky to be sold

The airspace portion of land has also been modernized with the concept of the condominium, a subdividing of the airspace which creates a relationship between the owners of separate adjacent air spaces classified as a corporate security (cooperatives) but now controlled as a *common interest development* (CID) in real estate.

An owner of a condominium unit legally owns the right to occupy the **parcel of airspace** he has acquired which is enclosed between the walls, ceilings and floors of the structure. Included in these ownership rights are incidental rights of ingress and egress, called *appurtenances*, and exclusive right to use other portions of the real estate for storage and parking, plus an undivided fractional interest in the common areas, directly or through an owner's association. [CC §1351(f)]

Also, the installation of active solar collectors has led to the right of access to sunlight and air which passes through airspace above property owned by others. This right of access to the sun for a solar collector is considered, by statute, an *easement*. [Calif. Public Resources Code §§25980 et seq.; CC §801.5(a)(1)]

## Water

Water in its natural state is considered land since it is part of the material of the earth. While water is real estate, the right to use water is an *appurtenant* (incidental) right to the ownership of real estate.

Three key rights in water must be separately understood and appreciated by brokers.

First, the **right to use** water is called a *riparian right*. **Riparian rights** refer to the rights of a real estate owner to take surface water from a running water source contiguous to his land, such as a river or stream. [Calif. Water Code §101]

Second, the **right to take** water can be acquired by *appropriation*. The appropriator of water diverts or **appropriates** water from a river or watercourse to his real estate and puts it to reasonable use. [**In re Water of Hallett Creek Stream System** (1988) 44 C3d 448]

Third, an individual may obtain *prescriptive rights* in water by wrongfully appropriating nonsurplus water openly and adversely under a claim of right for an uninterrupted period of at least five years. [**City of Barstow** v. **Mojave Water Agency** (2000) 23 C4th 1224]

However, all water in the state of California belongs to the people, under state auspices, based on a *public trust doctrine*. Riparian, appropriation, and prescriptive rights are subject to the state's interest in conserving and regulating water use. [Wat C §101]

Under the **public trust** theory, the state controls any unclaimed water rights for the highest and most beneficial use of the water. The State Water Resources Control Board determines the respective water rights of individuals and makes decisions based on the public interest and the needs of the individuals. [Wat C §2501; see Chapter 8]

## Affixed to the land

Real estate also includes things which are affixed to the land.

Things may be **affixed to the land** by:

- roots (e.g., shrubs and trees);
- embedment (e.g., walls);
- permanently resting (e.g., structures); or
- physically attached (e.g., by cement or nails). [CC §660]

Things attached to the earth naturally are real estate. Natural fixtures to the land include trees, shrubs, grass, etc. and are called *fructus naturales*.

However, natural items which are planted and cultivated for human consumption and use are fruits of labor, called *fructus industriales*.

**Fructus industriales** include such things as crops and standing timber. Crops and timber are ordinarily considered real estate. However, industrial crops and standing timber sold under a purchase agreement and scheduled to be removed are considered personal property. [Calif. Commercial Code §9102(a)(44)]

Crops and timber sold separately under a purchase agreement are treated as *constructively severed* even though actual removal has not yet occurred. [**Wilson** v. **White** (1911) 161 C 453]

## Fixtures

A fixture is a personal property item which has become permanently attached to real estate so as to become part of the real estate. [CC §660]

When personal property becomes a fixture, it is part of the real estate and is thereafter conveyed with the real estate.

Factors which determine whether an item is a fixture or improvement include:

- relationship of the parties;
- agreement between the parties;
- intention of the parties;
- manner of attachment; and
- adaptability of attachment to the real estate's use. [**San Diego Trust & Savings Bank** v. **San Diego County** (1940) 16 C2d 142]

Individuals most likely to dispute whether an item is a fixture include:

- buyers and sellers;
- landlords and tenants;
- a builder and an owner;
- a lender and an owner; and
- the county assessor and an owner.

The most important factor when determining whether an item is a fixture or improvement is the **intent of the parties**.

Intent to make an item a permanent part of the real estate as a fixture is determined by:

- the manner of attachment; and
- the use and purpose of the item in dispute.

When an item is attached to real estate by bolts, screws, cement or the like, the item is a fixture and part of the real estate. However, an item need not be attached to the real estate in this manner to be a fixture. Items of such weight and size that gravity maintains them in place is sufficient to give the item the character of permanence and affixation to be real estate.

Also, the item may be *constructively attached* when the item is a necessary, integral or working part of improvements on the real estate.

Another factor used to determine whether an item was intended by the parties to be a fixture is the *adaptability test*, which considers the circumstances under which the real estate is used. The **adaptability test** determines whether the item makes the real estate peculiarly valuable in its use by the owner or a tenant.

For example, a tenant enters into a lease which entitles him to use a wharf facility designed for handling cargo containers. Two container cranes, weighing 750 tons each, stand 100 feet high and operate on railbeds embedded in the land. The cranes are not attached to the land, but are on massive rollers.

The cranes are assessed by the county and a property tax lien is imposed on the real estate based on the assessed value of the cranes.

The tenant pays the tax and makes a demand on the county for a tax refund, which the county rejects.

The tenant claims the cranes are personal property and not part of the real estate since the cranes are not attached to the land, can be moved, and are not essential to the use and purpose of the land.

The county claims the cranes are fixtures and part of the real property since the weight of the cranes gives them the character of permanency and affixation to the land, the cranes comprise an integral and working part of the rails which are attached to the property, and the cranes are also an integral part of the facility specifically constructed for handling cargo containers.

In this scenario, the tenant is not entitled to a refund. The cranes, by virtue of their size and relationship to the purpose for ownership of the land, were intended to become a part of the real estate. [**Seatrain Terminals of California, Inc.** v. **County of Alameda** (1978) 83 CA3d 69]

In another example, a bank updates its accounting equipment by purchasing a state-of-the-art computer system.

A bank, as a service organization, does not pay personal property taxes assessed by the county, only local real estate taxes.

The bank installs computers in a building which are attached to cables installed throughout the building for hook-ups. The bank networks the various computers together.

The county assessor claims the computers have become a fixture since they are permanently attached to the building. If the computer system is considered part of the real estate and is no longer personal property, the bank must pay *ad valorem* property taxes on the value of the equipment.

The bank claims the computers are personal property since they are merely attached to the building by cords and can be readily removed, making them separate pieces of office equipment.

Are the computers, detachable by computer cables affixed to the building, also part of the real estate?

No! The bank never intended for the computers to become a permanent part of the real estate. [**Crocker National Bank** v. **City and County of San Francisco** (1989) 49 C3d 881]

## Trade fixtures

Fixtures which are used to render services or make products for the trade or business of a tenant are called *trade fixtures*.

**Trade fixtures** are to be removed by the tenant on termination of the tenancy, unless agreed to the contrary with the landlord. The removal must not unduly damage the real estate. [CC §1019]

Thus, trade fixtures are considered personal property.

The removal of trade fixtures is often negotiated between a landlord and tenant to confirm who has ownership of the fixtures on expiration of the tenancy. [**City of Beverly Hills** v. **Albright** (1960) 184 CA2d 562]

To be considered a trade fixture, a fixture must be an essential part of the tenant's business and its removal must not substantially damage the real estate. An example of trade fixtures would be mirrors, sink bowls, dryers and installed wash stations in a beauty salon. [**Beebe** v. **Richards** (1953) 115 CA2d 589; see Chapter 6]

## Substantial damage by removal

A tenant installs a refrigeration unit in a building it uses to operate a grocery store.

When the tenant's long-term lease expires, the tenant wants to remove the refrigeration unit to use at his new location. However, removal of the unit would put a large hole in the ceiling and cause structural damage which would subject portions of the building to collapse.

Is the refrigeration system a trade fixture, permitting the tenant to remove the unit on expiration of the lease?

No! The damage to the building caused by the removal would be too substantial. [**Goldberg** v. **Stanton** (1927) 84 CA 665]

Landlords frequently require tenant improvements to remain a part of the real estate after the tenant vacates.

For example, a landlord may agree to reduce rent in exchange for the tenant's installation of gas tanks, noting the gas tanks are not trade fixtures, but belong to the landlord and will remain after the tenant vacates the property. [**Southland Corporation** v. **Emerald Oil Company** (9th Cir. 1986) 789 F2d 1441]

## Appurtenant rights

Real estate also includes any **incidental rights** to the real estate which are not located on the real estate nor reflected on its title, called *appurtenant rights*. **Appurtenant rights** include the right of ingress and egress across adjoining properties. [CC §662]

An *appurtenant easement* is an interest held by an owner of one parcel of real estate to use adjoining real estate.

Under an **appurtenant easement**, an owner's **right to use** adjoining real estate is part of his real estate, although not reflected on the title to his real estate, and is automatically conveyed with the real estate when he sells it.

Appurtenant easements are said to *run with the land*. Thus, these easements are not personal to the owner of the real estate entitled to use them. They cannot be severed or retained by an owner when he sells the real estate since the right of an owner to use an easement is part of the real estate. Appurtenant rights are incidental rights which remain with the real estate they benefit and do not transfer from person to person.

Other appurtenant rights to real estate include the right to the *lateral and subjacent support* provided by the existence of adjoining real estate. For example, the owner of real estate cannot remove soil from his land so as to cause the adjoining real estate to subside or collapse.

Appurtenant rights which benefit an owner cannot be located in the public records by a search of the legal description for the real estate he owns. Appurtenant rights held by an owner of one property are a recorded encumbrance on title to the adjacent property burdened by the appurtenant rights, such as an easement.

# Chapter 7 — Fee vs. Leasehold

*This chapter examines the entitlement to possession of real estate held by owners of different interests in a parcel of real estate.*

## A matter of possession

The **ownership interests** a person may hold in real estate are called *estates*. Four kinds of **estates** in real estate exist:

- *fee estates*, sometimes referred to as *inheritance* or *perpetual estates*;
- *life estates*;
- *leasehold estates*, sometimes called *estates for years*; and
- *estates at will*. [CC §761]

In practice, these estates are separated into three categories: fee simple estates, leasehold estates and life estates.

A **life estate** terminates on the death of the owner of the life estate or the death of another person named as the controlling life in the deed conveying or reserving the life estate.

**Leasehold interests** held by a tenant in the real estate exist for a fixed period of time. The leasehold interest terminates when the period of time expires.

An **estate at will**, unlike a leasehold interest, is not conveyed in an exchange for value, called *consideration*. Estates at will terminate at the discretion of the fee owner, subject to proper advance notice.

Possession of real estate under leasehold interests and estates at will is controlled primarily by landlord/tenant law.

## The fee as three dimensional

An owner of a **fee interest** in real estate has absolute ownership of all the real estate for an *indefinite duration*.

A fee owner may do what he wants with his property as long as he acts within the laws affecting the use of his real estate interest. A fee owner is entitled to the land's surface and anything permanently located above or below it. [CC §829]

A fee owner may occupy, sell, lease or encumber his parcel of real estate. He may also give it away or pass it to his heirs or to anyone he chooses on his death. The fee estate is the interest in real estate typically transferred in a real estate sales transaction.

It is possible to separate one parcel of real estate into several fee interests, though it is infrequently done. One person may own the mineral rights beneath the surface of a property, someone else may own the surface rights, and yet another can own the rights to the air space — each interest being held in fee.

Consider a fee owner who sells and grants separate fee interests in his property to two individuals. One individual receives the land's surface and air space rights. The other individual receives the subsurface oil and mineral rights.

The surface owner claims the title to the entire parcel of real estate should be vested — *quieted* — in his name.

The subsurface owner objects, claiming the surface owner's real estate interest is less than the entire fee estate in the property.

In this scenario, the surface owner's fee interest in the parcel of real estate is separate from the subsurface ownership and possession of the oil and mineral rights beneath the surface of the parcel. They are not **co-owners** of any interest in the real estate even though both owners hold a fee estate in the same parcel. Their ownership interests are mutually exclusive, each owning separate portions of the same parcel. [**In re Waltz** (1925) 197 C 263]

## Life estates until death

A **life estate** is an interest in a parcel of real estate lasting the lifetime of a *life tenant* or someone else, called the *controlling life*. Life estates are granted by deed from the fee owner, or created by a court order under a will or a trustee under an inter-vivos (living) trust.

Life estates are commonly established by a fee owner who wishes to provide a home or financial security for someone else during that person's lifetime (or someone else's lifetime).

Life estates are *terminated* by:

- death of the controlling life;
- agreement; or
- merger of different commonly held ownership interests in a property.

For example, an owner of a vacation home has an elderly aunt who is in need of a decent place to live. The owner grants her a life estate in the vacation home for the duration of her lifetime. Thus, she may live in, rent or sell the property for the remainder of her life, even though the fee owner might predecease her.

Although the aunt has the right to exclusive possession of the entire parcel of real estate, the owner retains title to the fee. Thus, a life estate transfers a right to possession which has been "carved out" of the fee, comparable to possession under a lease which is conveyed out of the fee. Unlike a lease, a life estate does not require rent to be paid to own the life estate.

On the aunt's death, possession of the property reverts back to the fee owner or his heirs since the tenancy of the life estate is extinguished by the aunt's death.

The holder of a life estate based on his life has the right of possession until his death, as if he were the owner in fee. The holder of a life estate is responsible for taxes, maintenance and a reasonable portion of property assessments, such as improvement district bonds. [CC §840]

The holder of a life estate may not *impair* the fee interest. [CC §818]

For example, the holder of a life estate may not make alterations which decrease the property's value, such as removing valuable plants, improvements or land.

Conversely, the holder of a life estate has the right to lease the property and collect and retain any rents during the term of the life estate. Profit on the sale of the life estate may be taken in addition to rental income.

For example, a life estate tenant enters into a lease with a logging company to harvest trees from a property.

The property value is increased by the removal of the trees since the property's best use is as a farm and additional crops can be planted on the cleared land.

The fee owner claims the life tenant had no right to remove or sell the trees since they are improvements.

However, the life tenant did not injure the fee interest since he did not diminish its value, called *impairment*. The life estate tenant is entitled to the profits from selling timber or any other crops, provided the property's value is not impaired by their removal. [**Sallee** v. **Daneri** (1942) 49 CA2d 324]

A life tenant may be entitled to *reimbursement* from the fee owner for necessary costs of improving or retrofitting a property.

For example, a city inspector notifies a life tenant the property is not up to health and safety codes and will be demolished unless improvements and retrofitting occur.

The life tenant improves the property, satisfying code requirements since the life tenant has a duty not to impair the property's value by allowing its demolition. Due to the retrofitting and improvements, the property's value increased.

The life tenant makes a demand on the fee owner for his contribution to the cost of improvements, which the fee owner rejects.

In this instance, the fee owner is liable to the life tenant for the increased value of the fee ownership in the property, the result of the improvements to the property made by the life tenant. [**Eastman** v. **Peterson** (1968) 268 CA2d 169]

## Leaseholds conveyed out of the fee

**Leaseholds** denote the rights *conveyed* to a tenant by a fee owner (or life estate tenant or master lessee) to possess a parcel of real estate. Beyond possession, leaseholds are created by conveyance (in the lease agreement) of an interest in real estate.

A leasehold is an estate in real property. The tenant owns the leasehold estate. Leaseholds are created when the landlord and tenant enter into a lease or a rental agreement.

As the owner of a leasehold, the tenant has the right to possess and use the entire property until the lease term expires. Title to the fee interest in the property remains with the landlord (or his successor) throughout the term of the leasehold, subject to the tenant's possession *carved out of the fee* by the lease.

In exchange for the tenant's right to occupy the property, the landlord receives rental income for the period of the tenancy. Also, the tenant may encumber his leasehold interest with a trust deed as security for a loan. [CC§§2920, 2924 et seq.]

## Types of leaseholds by their term

Four types of **leasehold interests** exist which can be held by tenants. The interests are classified by the length of their term:

- a *fixed-term tenancy*, simply known as a *lease* (distinguishable from the document entitled a lease agreement) and legally called an *estate for years*;
- a *periodic tenancy*, usually referred to as a *rental agreement*;
- a *tenancy-at-will*; and
- a *tenancy-at-sufferance*, commonly called a *holdover tenancy*.

A **fixed-term tenancy**, an estate for years, lasts for a specific length of time agreed to in a lease agreement between a landlord and tenant.

When the lease expires, the lease with its right to possession terminates automatically — unless an agreement, such as an option right which is exercised, extends or sets a new expiration date.

A **periodic tenancy** also lasts for a specific length of time. However, in the creation of a periodic tenancy, a landlord and tenant agree to successive rental periods of the same length, such as in a month-to-month tenancy. The tenancy continues until terminated by notice from either the tenant or the landlord to the other.

A **tenant at will** has the right to possession of property with the consent of the owner. Tenancies at will are terminated at any time by notice from either party or by agreement. Tenancies at will have no fixed duration, are not usually in writing and no rent obligation exists.

## Special uses of leaseholds

In addition to typical residential and nonresidential leases, other leases exist which serve specific purposes.

**Oil, gas, water and mineral leases** convey the right to others to use mineral deposits below the earth's surface.

The purpose of an oil lease is to discover, extract and produce oil or gas. The oil lease is a tool used by the property owner to develop and realize the full value of his land. The tenant provides the money, machinery and man-power for exploration and development under the surface of the property. The tenant pays the landlord rent, called a *royalty*, and keeps any profits from the sale of the oil or minerals he extracts from beneath the surface of the parcel.

A **ground lease** is granted in exchange for the payment of rent, an amount which is based on the rental value of the part of the real estate called land, whether the parcel is vacant or improved. A lease is a *financing tool* for fee owners to induce others to acquire an interest in the property and develop it with improvements.

Ground leases are common in densely populated areas since developers need financial assistance from owners to avoid massive cash outlay to acquire unimproved land.

Owners of developable property who refuse to sell can become landlords for the long-term rental income they will receive from the property. The rental income is calculated as an annual percentage return, based on the value of the land, and usually paid monthly. Under a ground lease, the tenant constructs his own improvements. Both the owner and tenant own an interest in the same real estate.

A **master lease** benefits an owner who wants the financial advantages of renting fully improved property occupied by multiple tenants but does not want the day-to-day burdens and uncertainties of managing the property.

For instance, an owner of a shopping center and a prospective owner-operator agree to a master lease.

As the master tenant, the operator will collect rent from the many subtenants, and address their needs and concerns. The master tenant is responsible for the rent due under the master lease — even if the subtenants do not pay their rents.

This type of lease is sometimes called a *sandwich lease*, since the master tenant is "sandwiched" between the fee owner and the many subtenants.

A **master lease** is written up on a regular nonresidential lease agreement form with the deletion of the clause prohibiting assignments and subletting. A **sublease** is also a regular nonresidential lease agreement with the addition of a clause referencing the attached master lease and specifying the sublease is subject to the terms of the master lease.

Another type of special use lease is the *farm lease*, sometimes called *cropping agreements* or *grazing leases*. A tenant will operate a farm and pay the landlord either a flat fee for rent or a percentage of the value of the crops produced on the land.

## Fee ownership right to exclude

A fee owner has the right to possess and control his property. A fee owner's possession is exclusive and absolute. Thus, he has the right to deny others permission to cross his boundaries. No one may be on the owner's property without his consent. Should others enter the property without the owner's consent, they are guilty of a trespass. The owner may recover any money losses from the trespassers caused by a trespass.

A fee owner has the *exclusive right to use* and enjoy his property. As long as local ordinances such as building codes and zoning regulations are observed, a fee owner may do as he pleases with his property. A fee owner may build new buildings, tear old ones down, plant trees and shrubs, grow crops or simply leave the property unattended, unless agreed to the contrary in the covenants, conditions and restrictions (CC&Rs) or a trust deed.

As a landlord, the fee owner may receive rents for allowing others to use and occupy his property by leasing some or all of it to them.

Fee owners also have the *right of disposition*. Fee owners may retain ownership, occupy the property, lease it, encumber it, sell it, give it away, grant a life estate or pass it on to their heirs.

While an owner can dispose of property as he wishes, the document conveying or authorizing the conveyance of his interest, such as a will, inter vivos trust agreement or deed, must conform to the legal standards governing the conveyance intended.

## The rights of others in a property

*Easements* and *use licenses* are not real estate but they give a holder of the rights a limited and **nonexclusive use** of someone else's property. [See Chapter 20]

An **easement** is a *right to use* another's property for a specific purpose. An easement is an interest in someone else's real estate, as it grants its holder the right to limit the activities of others on the property which is burdened by the easement. [CC §§801 et seq.]

For example, a landowner holds an easement allowing him to construct and have access to a pipeline across his neighbor's property. The neighbor's right to develop his own property is limited since he may do nothing to interfere with the easement owner's access to the pipeline.

A *license* grants its holder a personal privilege to use property, but no right to occupy it to the exclusion of others. Unlike easements, **licenses** are not exclusive rights — an owner may give many licenses to perform the same or different activity in the same area. [See Chapter 10]

Unlike an easement, a license may be revoked at the will of the person who grants it, unless agreed to the contrary or it has become irrevocable.

For example, a landowner wishes to enjoin a neighbor from continuing to use a roadway across the landowner's property that the prior owner of the neighboring property used for ingress and egress to his property. The landowner claims the right to pass is a license, not an easement. The neighbor contends the grant of the right to use the road created an easement.

The landowner claims only a revocable license to use the road was created, as the previous neighbor was only granted a personal *in gross* right to use the road and that right is not assignable to the current neighbor.

Although the previous owner is mentioned, the document creating the right to use a roadway contains the crucial phrase "*his heirs or assigns*" when referring to the prior neighbor's right to use the roadway.

Thus, when the neighbor bought the property he obtained the irrevocable right to use the road as part of his ownership rights. The easement is an *appurtenant right* running with his land since it is physically located on the property of another and is an encumbrance on that property's title.

The roadway document created an easement which entitled the new owner of the neighboring property to cross the adjacent property for ingress and egress to his property from the main road. [**Eastman** v. **Piper** (1924) 68 CA 554]

**Covenants, conditions and restrictions (CC&Rs)**, collectively called *encumbrances*, are recorded against title to a property and limit an owner's right to use his property. By recording restrictions against the title to real estate on a sale, a seller may prohibit certain uses of the property, or require the property be used for specific purposes only.

Regulations governing how a condominium owner may use his unit and the rights and responsibilities of the common interest development (CID) are typically contained in a declaration of CC&Rs filed with the condominium subdivision plan.

The CC&Rs bind all future owners to comply with the CC&Rs since the use restrictions they contain run with the land.

# Chapter 8 Leasehold improvements

*This chapter discusses improvements made by tenants on leased property and the landlord's rights to these improvements.*

## Ownership rights

A retail business owner, as a tenant, enters into a nonresidential lease agreement for commercial space. The leased premises does not contain *tenant improvements* since the building is nothing more than a shell.

In the lease, the tenant agrees to make all the **tenant improvements** necessary for him to occupy the premises and operate his business (i.e., interior walls, flooring, carpeting, lighting, plumbing, telephone and electronic wiring, etc.). The tenant will also install trade fixtures on the premises.

The lease agreement provides for the property will be delivered to the landlord on *expiration* of the lease "in the condition the tenant received it" less normal wear and tear.

However, no other provision in the lease addresses whether:

- improvements made by the tenant will remain with the property; or
- the property will be restored to its original condition when the lease expires.

On **expiration** of the lease, the tenant strips the premises of all the improvements he made and vacates. The building is returned to the landlord in its original condition, a shell, less wear and tear. The landlord replaces nearly all the tenant improvements removed in order to relet the space and make a demand on the tenant for their replacement costs.

Is the tenant liable for the landlord's costs to replace the tenant improvements for the next tenant?

Yes! Improvements made by a tenant which are **permanently affixed** to real estate become *fixtures*, part of the real estate to which they are attached. **Fixtures** are to remain with the property on expiration of the tenancy, unless the landlord and the tenant agree to the contrary in the lease agreement. [Calif. Civil Code §1013]

With the exception of *trade fixtures*, improvements attached to the building become part of the real estate. [CC §660]

## Tenant improvements, fixtures and removal

A landlord's right to an improvement is conditioned on:

- the permanent or temporary nature of the improvements made by the tenant (i.e., built-in or free standing); and
- any lease provisions relating to the tenant removal of improvements or the *restoration* of the premises.

Examples of improvements which become part of the real estate include:

- built-ins (i.e., central air conditioning or heating, cabinets and stairwells);

- fixtures (i.e., electrical and plumbing);
- walls, doors and dropped ceilings; and
- flooring which is attached (i.e., carpeting, tile or linoleum).

On expiration of the lease, the landlord is entitled to property improvements and alterations made by the tenant, unless agreed to the contrary.

### Leasehold improvement provisions

Nonresidential leases do or should contain a *further-improvement* provision allowing the landlord to either retain tenant improvements and alterations made by the tenant or require **restoration** of the property to its original condition on expiration of the lease. [See **first tuesday** Form 552 §9]

The **further-improvement** provision usually includes clauses regarding:

- who will make the improvements (landlord or tenant);
- who will pay for the improvements (landlord or tenant);
- the landlord's consent is required before the tenant makes improvements;
- any mechanic's liens due to improvements contracted by the tenant will be removed;
- the condition of the premises on expiration; and
- whether the improvements are to remain or be removed on expiration of the lease.

### Improvements to be made by landlord

Consider a landlord who obligates himself under a lease to make improvements. Once agreed to, the landlord must complete the improvements in a *timely manner* so the tenant may use them or the lease may be terminated by the tenant.

For example, a landlord agrees to make all the improvements necessary to convert a ranch into a dairy farm for a tenant who operates a dairy.

The landlord is to construct a barn and several sheds which are essential to the operation of the tenant's dairy business.

The tenant moves into the property before the improvements begin. Several months pass and the landlord does not start construction on the promised improvements. The tenant vacates the property since it is impossible to conduct his dairy business without the barn and sheds.

In this example, the **landlord's failure** to make the promised improvements is a breach of the lease agreement.

Since the landlord has breached an essential provision of the lease, the tenant may vacate the property and terminate the lease without any obligation to pay further rent. [**Souza** v. **Joseph** (1913) 22 CA 179]

Now consider a landlord who agrees to construct the shell of a building for a tenant. The tenant agrees to install all other improvements and fixtures required to occupy and use the property.

However, before the building is completed by the landlord, the building code is changed to require the installation of a sprinkler system. The tenant demands the landlord pay the cost of installing the sprinkler system since he cannot occupy the premises without the sprinkler system.

The landlord refuses to pay the additional cost to install the sprinkler system claiming the lease agreement calls for him to build the structure, not to make it ready for occupancy.

Is the tenant responsible for the cost of the sprinkler system?

Yes! It is the tenant's responsibility to make the alterations or improvements required to bring the building into compliance with use (occupancy) ordinances since the tenant agreed to make all improvements to the structure needed in order to take occupancy. [**Wong** v. **DiGrazia** (1963) 60 C2d 525]

Alternatively, lease provisions can obligate a tenant to improve vacant, unimproved property, such as occurs with ground lease arrangements.

## Improvements promised by the tenant

A tenant must complete the improvements he has agreed to construct or install on the leased premises within the time period agreed to in the lease or in a **timely manner** if no commencement or completion date for construction is agreed to in the lease. [CC §1657]

However, if the tenant fails to make or complete mandated improvements prior to expiration of the lease and the improvements were to remain with the property on expiration of the lease, the tenant is liable to the landlord for the cost incurred to complete the agreed-to improvements.

For example, a tenant agrees to construct additional buildings on leased property in lieu of paying rent for a one-year period. When the lease expires, the improvements will remain with the property.

The tenant fails to construct the buildings during the term of the lease. The tenant claims the lease provision calling for construction is permissive, not mandatory, since he only had to build if he needed to do so for the operation of his business.

However, the improvements were agreed to in *exchange for rent*. The tenant is obligated to make the improvements since the landlord bargained for them in the lease agreement. Thus, the landlord is entitled to recover an amount equal to the cost of the improvements the tenant failed to construct. [**Simen** v. **Sam Aftergut Co.** (1915) 26 CA 361]

Additionally, if the tenant agrees to and does not complete the construction of improvements which are to remain with the property on expiration of the lease, the landlord may complete the improvements. The tenant is then responsible for the landlord's expenditures to construct the improvements he agreed to construct. [**Sprague** v. **Fauver** (1945) 71 CA2d 333]

The landlord is also entitled to recover lost rent and expenses incurred after the expiration of a lease resulting from the tenant's failure to construct the promised improvements.

Consider a landlord who enters into a lease and agrees to construct a building for the tenant. However, after the foundation is laid, the landlord and tenant orally modify the construction arrangement. The tenant agrees to finish construction of the building in exchange for the landlord relinquishing his construction profit.

The tenant breaches the *oral modification* of the written lease by failing to complete the construction of the building. The breach places the landlord in financial jeopardy since he now must complete the building himself and relet it. The landlord terminates the lease, evicts the tenant and completes the construction promised by the tenant.

In this example, the tenant is not only responsible for the landlord's costs of construction, he is also liable for lost future rents and any expenses the landlord incurs to relet the property. [**Sanders Construction Company, Inc.** v. **San Joaquin First Federal Savings and Loan Association** (1982) 136 CA3d 387]

## Landlord's consent to improvements

Lease provisions often allow a tenant to make improvements to the leased premises. However, further-improvement provisions typically call for the landlord to approve the planned improvements before construction is started.

For example, a tenant wishes to add a room to his leased premises to operate his business. The tenant begins construction without the landlord's prior approval as called for in the lease. The addition is located in space outside the area described in the lease as the leased premises, resulting in an encroachment on other land owned by the landlord.

In the past, the landlord has approved other improvements made by the tenant. However, this time the landlord refuses to give consent and complains about the tenant's construction and the encroachment.

The landlord continues to accept rent while he negotiates with the tenant regarding the approval of the addition and the modification of the lease to include the area subject to the encroachment.

Ultimately, after a few years of negotiations without a resolution, the landlord declares a *forfeiture of the lease* based on both the breach of the provision requiring his prior consent to construction and the encroachment of the unapproved improvements.

The tenant claims the landlord has *waived* his right to declare a **forfeiture of the lease** since the landlord continued to accept the rental payments after the breach and encroachment.

However, a landlord does not waive his right to consent to additional improvements by accepting rent from the tenant as long as negotiations to resolve the breach continue. [**Thriftimart, Inc.** v. **Me & Tex** (1981) 123 CA3d 751]

Likewise, when a tenant with an option to buy makes improvements with the expectation he will ultimately become the owner of the property, the landlord's consent to improvements called for in the lease is needed before any improvements can be made.

Further, the tenant is not entitled to reimbursement for the cost of improvements, whether or not the landlord consents to the improvements. The improvements will not become the tenant's unless he exercises his option to buy. [**Whipple** v. **Haberle** (1963) 223 CA2d 477]

## Permissive improvements by the tenant

Some lease provisions allow a tenant to make improvements, but do not specifically mandate that he do so.

For instance, a landlord and tenant sign a long-term lease. A lease provision authorizes the tenant to demolish an existing building located on the property and construct a new one in its place without obtaining the landlord's prior consent. The rent is based on the current value of the premises.

However, the lease provision does not state a specific time period for demolition or construction.

The tenant does not make an effort to tear down the old building or erect a new one. Ultimately, the landlord claims the tenant has breached the lease for failure to demolish the existing building and construct a new one.

However, the tenant has not breached the lease. The tenant was not obligated to build since the lease contained no promise by the tenant to build. The tenant was merely *authorized to build* without the need for further consent.

Thus, the tenant was granted a **privilege** to make improvements. Further improvements on the tenant's part were not mandatory, they were permissive. [**Kusmark** v. **Montgomery Ward and Co.** (1967) 249 CA2d 585]

Now consider a lease provision requiring that a tenant construct improvements on a vacant parcel he has leased. A date is not specified for completion of the improvements. Since construction of improvements is mandated to occur, the tenant must complete construction within a reasonable period of time.

For example, a landlord leases unimproved land to a tenant who is a developer. The tenant is obligated to build improvements, contingent upon his ability to obtain a construction loan. A time period is not set for commencement or completion of the construction. Also, no provision authorizes the landlord to terminate the lease if the required construction is not completed.

However, the lease gives the tenant the right to terminate the lease after one year if financing is not found to fund the construction.

The tenant does not find financing within the one-year period. However, the tenant does not exercise his right to cancel the lease and avoid the payment of future rents. Instead, the tenant continues his good faith effort to locate and qualify for construction financing. Ultimately, financing is not located and construction is not commenced.

A few years after commencement of the lease, the landlord claims the lease has been breached for lack of the promised construction.

The tenant claims the landlord cannot terminate the lease as long as the tenant continues his good faith effort to locate financing and remains solvent to qualify for the financing.

In this example, the tenant breached the lease. He failed to construct the intended improvements within a **reasonable period of time**. The original purpose of the lease was to have buildings erected without specifying a completion date. However, the landlord did give the tenant a reasonable amount of time — forty months — in which to procure financing for the transaction before terminating the lease.

A landlord cannot be forced to leave the property unimproved forever when the original intention under the lease was to develop the land. [**City of Stockton** v. **Stockton Plaza Corporation** (1968) 261 CA2d 639]

## Surrender of improvements

All tenant improvements and alterations are to remain with the leased property on expiration or other termination of the lease, unless a lease provision exists **permitting** or **mandating removal** by the tenant.

Most leases merely provide for the property to be returned in *good condition*, less normal wear and tear for the years of the tenant's occupancy.

Thus, the tenant is not required, much less allowed, to *restore* the property to the actual condition he received it in when he took possession. The covenant for ordinary care of the premises during the lease does not mean removal of tenant improvements or renovation to eliminate deterioration, obsolescence or wear and tear due to the use permitted to the tenant. [**Kanner** v. **Globe Bottling Co.** (1969) 273 CA2d 559]

Consider a landlord and tenant who enter into a lease of nonresidential property. The lease agreement contains a provision requiring the tenant, if the landlord at his option so demands, to *restore* the premises to the original condition received by the tenant, less normal wear and tear.

The tenant makes all the tenant improvements necessary to operate his business, such as installation of a concrete vault, the removal of partitions and a stairway, and the closing of two entrances into the premises.

On expiration of the lease, the tenant vacates the premises. The landlord exercises his right to require removal of tenant improvements by making a demand on the tenant to **restore** the premises, which the tenant rejects.

The landlord incurs costs to restore most of the premises to prepare it for reletting to a new tenant.

The landlord claims the tenant is liable for costs he incurred to restore the premises since the tenant's improvements radically altered the premises and made it unrentable to others.

The tenant claims he is not liable for the landlord's costs to remove the improvements and restore the premises to its original condition since the alterations are beneficial to the property.

Is the tenant liable for the landlord's costs to restore the premises to a rentable condition?

Yes! On expiration of the lease, the tenant is obligated to restore the premises to its original condition, less normal wear and tear. The lease provided for restoration by the tenant on a demand from the landlord. The tenant improvements made the premises less desirable and unsuitable for other occupants.

On the tenant's failure to restore the premises, the landlord was forced to incur restoration expenses to relet the premises. Thus, the tenant is liable for the landlord's expenditures to restore the premises in order to relet it to a new tenant. [**Masonic Temple Ass'n. of Sacramento** v. **Stockholders Auxiliary Corporation** (1933) 130 CA 234]

In another example, a lease states a tenant will return the property in *good repair* and *restore* the premises to its original condition, less normal wear and tear.

The tenant modifies the premises to run his business. After the lease expires, the tenant moves out and leaves all his improvements and modifications on the property.

The landlord is unable to relet the premises in the condition left by the tenant.

In this example, the tenant is liable for the reasonable costs incurred by the landlord to restore the premises to its original condition and for lost rental income for the period of time it takes to make the repairs.

Thus, lease provisions requiring **restoration** of the premises to its original condition require the tenant to restore the property to its original condition, minus any normal deterioration due to time and use of the premises as permitted. [**Iverson** v. **Spang Industries** (1975) 45 CA3d 303]

If a lease does not require the tenant to **restore the property** to the condition it was in when received, the tenant may only remove his personal improvements, called *trade improvements* or *trade fixtures*.

The tenant need only leave the property and tenant improvements in good condition. [**Formosa Corp.** v. **Rogers** (1951) 108 CA2d 397]

### Evicted tenant reimbursed for improvements

Compensation may be due to a tenant who has improved his property and is evicted prior to expiration of the lease.

A tenant who is evicted is entitled to the **rental value** of his improvements for the remainder of his unexpired lease term.

The tenant is not, however, entitled to reimbursement for the market value or cost of the improvements. Since reimbursement for costs is not required, the landlord receives a windfall profit for his use of the tenant's improvements until they revert to him on expiration of the original lease.

Thus, an evicted tenant is limited to collecting the reasonable value for the **landlord's use** of the improvements during the remainder of the term on the original lease. [**Asell** v. **Rodrigues** (1973) 32 CA3d 817]

### Real estate fixtures vs. trade fixtures

Two types of **fixtures** exist to distinguish improvements installed on buildings located on a parcel of real estate:

- *real estate fixtures*; and
- *trade fixtures*.

A **real estate fixture** is personal property which has become **attached** to the real estate. It becomes part of the real estate it is attached to and is conveyed with the property. [CC §§660, 1013]

In other words, if a tenant rents an office and builds bookshelves into the wall rather than merely anchoring them to the wall, the bookshelves become part of the improvements located on the real estate.

When the lease expires, real estate fixtures are the property of the landlord. The landlord takes possession of the real estate fixtures as part of the real estate surrendered to the landlord, **unless the lease provides for restoration** or permits removal of the improvements by the tenant. The passage of real estate fixtures from tenant to landlord on expiration of the lease is a conveyance called *reversion*. [**City of Beverly Hills** v. **Albright** (1960)184 CA2d 562]

However, *trade fixtures* do not revert to the landlord on expiration of the lease.

A **trade fixture** is an improvement which is attached to the real estate by the tenant that is peculiar to the operation of his business.

For example, a tenant leases property to operate a beauty salon. The tenant moves in work-related furnishings (i.e., mirrors, salon chairs, wash stations, dryers and the security system) which are needed to run the business. The items are attached to the floor, walls, plumbing and electrical leads.

On expiration of the lease, the tenant removes the fixtures which were used to render the services offered by the business. The landlord claims the fixtures are improvements to his property and cannot be removed since they have become part of the real estate.

However, furnishings which are unique to the operation of the business are considered trade fixtures even though the furnishings are attached and built into the structure. Thus, they are removable by the tenant.

A tenant may remove any trade fixtures at the end of or anytime during the lease term if the removal can be done without damaging the premises. [**Beebe** v. **Richards** (1953) 115 CA2d 589]

Fixtures that have become an integral part of the building structure due to the way they are attached or the general purpose they serve cannot be removed. Examples of fixtures not used to render services include toilets, air conditioners, vent conduits, sprinkler systems and lowered ceilings. [CC §1019]

### Trade fixtures as security

Lease agreements often contain a default provision prohibiting a tenant from removing trade fixtures when he breaches the lease. The tenant (and a tenant's unsecured creditors) no longer have a right to the trade fixtures under a default provision.

Consider a tenant who signs a commercial lease agreement to use the premises to operate a frozen packaging plant on the premises.

The lease states all fixtures, trade or leasehold, will belong to the landlord should the lease be terminated due to a breach by the tenant.

The tenant later encumbers his trade fixtures by borrowing money against them. The tenant later defaults on his lease payments.

While in default on the lease, the tenant surrenders the property to the landlord, including all trade fixtures.

Does the lender secured by the trade fixtures have a right to repossess them?

No! The tenant lost his ownership right to remove the trade fixtures under the lease. Any right to the fixtures held by the secured lender is similarly lost since the lender is junior in time and thus subordinate to the landlord's interest in the fixtures under the lease.

However, if the trade fixtures installed by the tenant are owned by a third party, or if a third party had a lien on them at the time of their installation, the landlord has no more right to them than the tenant. [**Goldie** v. **Bauchet Properties** (1975) 15 C3d 307]

### Notice of Nonresponsibility

A landlord may find himself paying for improvements made by the tenant if he fails to:

- **post** a notice on the premises of his intention not to be responsible for the improvements, called a *Notice of Nonresponsibility*; and
- **record** the notice with the county recorder. [See **first tuesday** Form 597 accompanying chapter 40]

Tenants occasionally contract for improvements to be constructed on the premises they have leased. Any **mechanic's lien** by a contractor for nonpayment initially attaches to the tenant's leasehold interest in the property. [CC §3128]

However, the mechanic's lien for unpaid labor and materials may also attach to the *fee simple* interest held by the landlord if the landlord or his property manager:

- acquires knowledge the construction is taking place; and
- fails to post and record a Notice of Nonresponsibility.

A **Notice of Nonresponsibility** is a written notice which must be:

- posted in a conspicuous place on the premises within ten days after the landlord or his property manager first has knowledge of the construction; and
- recorded with the county recorder's office within the same ten-day period. [CC §3094]

However, the landlord who becomes aware of the construction and fails to post and record the nonresponsibility notice is not personally liable to the contractor. Rather, the contractor can only lien the landlord's interest in the real estate and then foreclose on his lien to collect for unpaid labor and materials delivered to improve the property under contract with the tenant. [**Peterson** v. **Freiermuth** (1911) 17 CA 609]

Further, a mechanic's lien can attach to the landlord's interest even when he has posted and recorded a Notice of Nonresponsibility if the lease requires the tenant to make improvements.

For example, a lease states the tenant is to make certain improvements as a condition of renting the property. Since the improvements are not permissive, the tenant is deemed to be the **landlord's agent** when he contracts for the construction of the mandated improvements.

Thus, the mechanic's lien incurred by the tenant will attach to both the tenant's and the landlord's interest in the property despite any posting and recording of a Notice of Nonresponsibility. The lease mandated the tenant to construct improvements. [**Los Banos Gravel Company** v. **Freeman** (1976) 58 CA3d 785]

Had the lease merely authorized the tenant to make nonmandatory (permissive) improvements or make improvements subject to or without the landlord's prior consent, the tenant is not then acting as an agent for the landlord. Thus, the landlord's interest in the property will not be subject to a mechanic's lien if the Notice of Nonresponsibility is timely posted and recorded on discovery of the tenant improvements. [**Baker** v. **Hubbard** (1980) 101 CA3d 226]

Additionally, a mechanic's lien cannot be recorded against the landlord if the improvements are removed by the contractor recording the lien.

For example, a tenant contracts to have air conditioning installed in his building. The contractor sells the equipment to the tenant under a conditional sales contract. The contractor retains title to the equipment as security until the sales contract debt is paid.

The landlord's consent to the improvements is not obtained by the tenant, but the landlord has knowledge the work has commenced. The landlord does not post a **Notice of Nonresponsibility**.

Later, after the air conditioning units are installed, the tenant vacates the property.

The contractor is not paid and files a mechanic's lien against the landlord's fee interest in the property. Further, the contractor repossesses the air conditioning units and resells them at a loss, which he now seeks to recover under his lien.

However, by his election to repossess the units, the contractor waived his right to pursue the mechanic's lien to foreclosure.

Whether the air conditioning units are considered a removable fixture due to the financing, or a property improvement permitting the recording of a mechanic's lien, is no longer an issue after their removal.

The contractor removed the air conditioning units as authorized by the conditional sales contract and chose to treat the units as personal property, not real estate fixtures. Thus, the contractor lost his lien rights for nonpayment. [**Cornell** v. **Sennes** (1971) 18 CA3d 126]

Consider the tenant who leases a property containing tanks for holding gasoline. The tenant negotiates a reduced rental payment in exchange for installing fuel pumps free of any liens.

The tenant purchases the pumps on credit and the pumps are installed. The supplier of the pumps does not receive a Uniform Commercial Code (UCC-1) financing statement from the tenant, and thus does not file a UCC-1 with the Secretary of State, a requisite to *perfecting* the supplier's lien on the pumps.

Later, the pump supplier claims title to the pumps due to the unpaid installation debt and seeks to repossess them.

However, the landlord owns the pumps as fixtures which became part of the real estate. He gave consideration in the form of reduced rent to acquire the pumps. More importantly, the pump supplier failed to perfect its lien on installation of the pumps. [**Southland Corp.** v. **Emerald Oil Company** (9th Cir. 1986) 789 F2d 1441]

# Chapter 9 — Types of tenancies

*This chapter presents the different types of tenancies and how each is established.*

## Know your tenancy or lose time

A landlord and tenant enter into a lease agreement without including an **option to renew** or extend the term of the occupancy on expiration of the lease.

Several months before the lease expires, they begin negotiations to enter into a new lease agreement extending the term of occupancy. An agreement is not reached before the original tenancy expires. The tenant remains in possession on expiration of the lease — an unlawful detainer of the premises, commonly called a holdover, unless agreed to.

The landlord and tenant continue lease negotiations. Meanwhile, the tenant pays monthly rent at the same rate he was paying when the lease expired, which the landlord accepts.

Ultimately, they fail to agree on the terms for a new lease. The landlord then serves a notice on the tenant to either **stay and pay** a substantially higher monthly rent or **vacate** and forfeit the right to possession. [See **first tuesday** Forms 569, 571 and 579]

The tenant does neither; he remains in possession and does not pay the increased rent.

Can the landlord file an unlawful detainer (UD) action and proceed to evict the tenant on expiration of the notice and without further notice?

Yes! The tenant went from a fixed-term tenancy (the lease) to a tenancy-at-sufferance on expiration of the lease (a holdover), then to a periodic (month-to-month) tenancy on the landlord's acceptance of rent for occupancy after the lease expired. The right to possession under the periodic tenancy ended due to the expiration of the notice and the tenant's failure to pay rent (set by the notice).

## Tenancies as leasehold estates

Tenancies are possessory interests in real estate, called *leasehold estates*.

Four types of tenancies exist:

1. Fixed-term tenancies.
2. Periodic tenancies.
3. Tenancies-at-sufferance.
4. Tenancies-at-will.

To initially establish a tenancy, a landlord must somehow **transfer to the tenant** — either in writing, orally or by his conduct — the right to occupy the real estate. If the landlord does not transfer the right to occupy, the occupant who takes possession is a *trespasser*.

All tenancies have an agreed-to termination date or are capable of termination by notice. Termination of a **fixed-term tenancy** held by the tenant, which was conveyed by the **lease agreement**, occurs on the expiration date stated in the lease and without further notice.

A month-to-month rental agreement conveys an automatically renewable periodic tenancy, which is terminated by service of a notice to vacate at any time or a 3-day notice to vacate on a breach of the rental agreement.

A tenant's possessory interest in real estate can shift from one type of tenancy to another due to:

- a notice;
- expiration of a lease; or
- by conduct.

Thus, before a landlord can file a UD action and proceed with the eviction process based on an unlawful detainer of the premises by the tenant, the tenant's **right to possession** under his tenancy must be terminated by the proper notice to vacate (quit), unless the tenant holdover is under an expired lease.

In our opening example, the tenant traversed three types of **tenancies**:

- *fixed-term* (lease);
- *sufferance* (no agreed-to holdover); and
- *month-to-month* (acceptance of monthly payments), also called a *periodic tenancy*.

The tenant entered into his occupancy under a fixed-term tenancy, a leasehold estate commonly called a *lease*. During the term of the lease, the tenant can only be evicted for cause — and then only after the service of a 3-day notice to cure the breach or vacate (quit) the property. [See **first tuesday** Form 576]

On expiration of a lease, the tenant who remains in possession without an agreement or acceptance of rent by the landlord for the extended occupancy becomes a **holdover tenant**, legally called a *tenant-at-sufferance*. The landlord does not have to serve a notice to vacate on the holdover tenant before filing a UD action to evict the tenant. [Calif. Code of Civil Procedure §1161(1)]

However, if the landlord accepts monthly rent from a tenant in payment for his continued occupation after expiration of the lease, a month-to-month tenancy is established on the terms and conditions of the expired lease agreement, unless a renewal or extension option exists. When an option to renew or extend exists, the lease is renewed or extended by the post-expiration acceptance of the rent called for in the option. [Calif. Civil Code §1945]

To terminate a month-to-month tenancy which was created by acceptance of monthly rent after expiration of a lease which is not in default, the landlord must serve the tenant with a proper notice to vacate before filing a UD action. [**Colyear** v. **Tobriner** (1936) 7 C2d 735]

## Fixed-term tenancy

A **fixed-term tenancy**, also known as an *estate for years* or more commonly as a *leasehold*, is the result of an agreement between the landlord and the tenant for a fixed time period, typically called a *lease*. [CC §761]

The occupancy under a lease agreement must have a beginning date, called the *commencement date*, and an ending date, called the *expiration date*. If the rental period is longer than one year, the lease arrangements must be in writing and signed by the landlord and tenant to be enforceable, called a *lease agreement*, and sometimes loosely referred to as *the lease*. [CC §1624]

In a fixed-term tenancy, the tenant has an exclusive right to possession of the premises for the term of the occupancy stated in the lease agreement. On expiration of the lease, the tenancy automatically ter-

minates. The tenant is not entitled to any notice to vacate other than the notice provided by the tenancy's expiration date stated in the lease agreement. [CCP §1161(1)]

For example, a landlord and tenant orally agree to a six-month lease. At the end of six months, the landlord and tenant orally agree to another six-month lease.

At the end of the second term, the tenant refuses to vacate. The tenant claims the landlord must first serve him with a notice to vacate.

Here, the tenant is not entitled to any further notice beyond the agreed-to termination date. The oral occupancy agreement was not a periodic tenancy, such as a month-to-month rental agreement, even though it contained monthly rent payments. Instead, the occupancy agreement was a fixed-term lease with a set expiration date.

Thus, the tenant's right to possession terminates on expiration of the orally agreed-to six-month period. The oral lease agreement is enforceable since it was for a term of less than one year. [**Camp** v. **Matich** (1948) 87 CA2d 660]

A **fixed-term tenancy** provides a tenant with several advantages:

- the right to occupy for the fixed term;
- a predetermined rental amount; and
- limitations on termination or modification.

However, some disadvantages also exist for the fixed-term tenant:

- the tenant is liable for the total amount of rent due over the entire term of the lease (subject to the landlord's duty to mitigate losses); and
- the tenant may want to vacate prior to expiration of the leasing period and assign or sublet the premises to a new tenant to cover rent obligations, but cannot due to prohibitions in the lease against his transfer of possession, called *restraints on alienation*.

## Periodic tenancy

If the landlord finds a fixed-term tenancy too restrictive or inflexible for his financial purposes or use requirements, a periodic tenancy may be more suitable.

A periodic tenancy automatically continues for **successive periods**, each for the same length of time, until terminated by a notice to vacate. The length of each successive period of time is determined by the interval between scheduled rental payments.

Examples of **periodic payment** intervals include:

- annual rental payments, indicating a year-to-year tenancy;
- monthly rental payments, indicating a month-to-month tenancy; and
- weekly rental payments, indicating a week-to-week tenancy.

Consider a property manager who rents an apartment to a tenant under a fixed-term lease for one year. At the end of the leasing period, the tenant retains possession and continues to pay rent monthly, which the property manager accepts.

Later, the tenant is served with a notice to vacate. On the running of the notice, the tenant refuses to vacate. The tenant claims he is now a tenant-at-will and entitled to an additional 3-day notice to vacate

before he is unlawfully detaining the property since the notice to vacate served on him merely terminated his right to possession and made him a tenant-at-will on expiration of the notice.

However, an occupancy agreement for an **indefinite term** with a monthly rent schedule is a month-to-month tenancy. Thus, a tenant is only entitled to one notice to vacate before a UD action may be filed to evict him. [**Palmer** v. **Zeis** (1944) 65 CA2d Supp. 859]

The flexibility of a periodic tenancy allows the landlord and the tenant to terminate a month-to-month tenancy by giving the appropriate notice to vacate to the other party. [CC §1946]

Also, the operator of a **residential hotel** may not require a resident to change units or to check out and re-register in order to avoid creating a month-to-month tenancy and falling under landlord/tenant law. A residential hotel operator violating this rule is liable for a $500 civil penalty and attorney fees. [CC §1940.1]

## Tenancy-at-sufferance

When a fixed-term (lease) or periodic (month-to-month) tenancy terminates by prior agreement or notice, the tenant who remains in possession — a *tenant-at-sufferance* — unlawfully detains the property from the landlord.

A tenant-at-sufferance is more commonly called a *holdover tenant*. A holdover tenant retains possession of the premises without any contractual right to do so, a situation called an *unlawful detainer.*

A **holdover tenant** no longer owes rent under the expired lease or terminated rental agreement since he no longer has the right to possession. However, the lease or rental agreement usually calls for a penalty rate of daily rent owed for each day the tenant holds over. Without a holdover rent provision, the tenant owes the landlord the *reasonable rental value* of the property, a daily rate owed for each day the tenant holds over in possession after expiration of his tenancy.

Holdover rent is due **after** the tenant vacates or is evicted, when the holdover period is known and the amount owed can be determined.

The landlord's acceptance of "holdover" rent **prior** to the tenant vacating or being evicted establishes a periodic tenancy on receipt of the rent.

For example, a tenant with a fixed-term lease holds over after the lease agreement expires. The lease agreement contains no provisions for the amount of rent due during any holdover period.

On the tenant's failure to vacate, the landlord serves the tenant a notice to either pay a rent amount substantially higher than rental market rates or vacate. The tenant refuses to pay any rent or vacate.

The landlord files a UD action seeking payment of rent at the rate stated in the notice to pay or quit since the tenant did not vacate.

At the UD hearing, the landlord is awarded the reasonable market rental value for the entire time the tenant held over, not the higher rent demanded in the notice to pay or quit. The tenant never paid nor agreed to pay any amount of rent after the lease expired. Thus, a periodic tenancy was not established.

The higher rental amount demanded in the notice to pay or quit was not accepted by the holdover tenant since he refused to pay it. Thus, a UD court will only award a reasonable rental value for the time period the tenant held over since he is a tenant-at-sufferance in unlawful possession of the property. Also, the

notice to (pay or) quit was not needed to evict the tenant on expiration of the lease. [**Shenson** v. **Shenson** (1954) 124 CA2d 747]

### Expired first refusal as a holdover

Now consider a tenant who enters into a fixed-term lease for the second floor of a building.

Without a charge for additional rent, the tenant will also take and retain possession of the third floor until the landlord secures a *bona fide tenant*. The tenant has the **right of first refusal** to rent the third floor should the landlord find a tenant. If the tenant does not exercise his right of first refusal to rent the third floor, his right to possession of the third floor ends.

The tenant moves into the second and third floors of the building. Later, the landlord locates a prospective tenant to rent the third floor.

The landlord notifies the tenant he must immediately exercise his right of first refusal or vacate the third floor.

The tenant does not exercise his right of first refusal and refuses to move. The tenant claims he is a tenant-at-will with the right to receive a notice to vacate before his right to occupancy can be terminated.

However, the tenant's lease of the third floor had a *specific termination date* — the date the tenant fails to exercise his right of first refusal. Thus, he is a tenant for a fixed-term and not a tenant-at-will since his occupancy ended on expiration of his right of first refusal.

The tenant, now a holdover, becomes a *tenant-at-sufferance* on expiration of his right of first refusal. Thus, the tenant is not entitled to any further notice to quit before his unlawful detainer of the premises is established. The tenant's notice of the date of termination of the occupancy was his failure to exercise his right of first refusal prior to its expiration. [**Vandenbergh** v. **Davis** (1961) 190 CA2d 694]

For the tenant with a right of first refusal to also be entitled to an additional period of lawful occupancy and a notice to vacate after expiration of a lease, a provision so stating must be included in the lease agreement or the right of first refusal agreement.

### Sufferance for the fired tenant-employee

A **tenancy-at-sufferance** also arises when a resident manager's compensation includes the right to occupy a unit rent-free. When the landlord terminates the employment and the resident manager fails to vacate immediately, a tenancy-at-sufferance exists.

For example, a landlord hires a caretaker to do general maintenance work around an apartment complex in exchange for rent-free possession of a unit in the complex.

Several months later, during a dispute with the landlord, the tenant refuses to work, which results in his dismissal as an employee.

The landlord delivers a notice to the tenant to immediately pay rent (as demanded in the notice) or quit. The tenant does neither and the landlord files a UD action.

The tenant contends he is a tenant-at-will, entitled to a notice to vacate before the landlord can establish an unlawful detainer and file his UD action.

However, the tenant's right to occupancy ended when his employment ended, the expiration of a fixed-term lease. Thus, the tenant became a **holdover tenant** who was not entitled to notice, other than the notice from the landlord *terminating the employment*, before the landlord could commence a UD action to evict him. [**Karz** v. **Mecham** (1981) 120 CA3d Supp. 1]

If the employee is to receive notice and time to pay or vacate on termination of his employment (and right to occupancy), his employment agreement must provide for it.

Under rent control ordinances, a tenant-at-sufferance must receive a notice to vacate. However, courts in rent-controlled areas have exempted employee-tenants from rent control protection by classifying them, for purposes of rent control, as licensees rather than tenants.

Yet, employee-tenants clearly are not licensees (for any other purpose) since they have exclusive rights to occupy the unit assigned to them. [**Chan** v. **Antepenko** (1988) 203 CA3d Supp. 21]

## Tenancy-at-will

The characteristics of a *tenancy-at-will* include:

- possession delivered to the tenant with the landlord's knowledge and consent;
- possession for an indefinite and unspecified period; and
- no provision for the payment of rent.

For a **tenancy-at-will**, a written notice to vacate or pay rent is required to make any change in the right to occupy the premises. However, the parties can always agree to a shorter or longer notice period. [CC §§789, 1946]

For example, an owner-occupant agrees to sell his office building under a purchase agreement providing for him to retain the **free use and possession** of the property after closing until he can occupy an office building he is constructing. Thus, a tenancy-at-will is created.

The buyer agrees in the purchase agreement to give the seller a 90-day written notice to either vacate the property or pay rent.

The buyer resells the property to a new owner. The new owner demands the tenant-seller pay rent or vacate immediately. The new owner claims he is not subject to the prior owner's **unrecorded agreement** to give a 90-day notice.

However, the new owner acquired the property subject to the rights held by the tenant in possession. Thus, the new owner is charged with *constructive knowledge* of the unrecorded agreement regarding notices and took title subject to the terms of the agreement.

Until the tenant-at-will receives the appropriate notice to vacate, he is not unlawfully detaining the property and the owner/landlord cannot proceed with a UD action to recover possession. [**First & C. Corporation** v. **Wencke** (1967) 253 CA2d 719]

However, a tenancy-at-will is automatically terminated if the tenant **assigns or sublets** his right to occupy the property to another tenant. The new tenant becomes a tenant-at-sufferance or a trespasser. [**McLeran** v. **Benton** (1887) 73 C 329]

Also, the tenancy-at-will terminates on the **death** of either the landlord or tenant, unless an agreement to the contrary exists. [**Dugand** v. **Magnus** (1930) 107 CA 243]

Other situations giving rise to a tenancy-at-will include:

- when a tenant with the right to indefinitely occupy the property in exchange for making improvements fails to make the improvements [**Carteri** v. **Roberts** (1903) 140 C 164];
- when a tenant takes possession of the property under an **unenforceable lease agreement** (e.g., the written lease with terms orally agreed to was never signed by any of the parties) — unless rent is accepted, which establishes a periodic tenancy [**Psihozios** v. **Humberg** (1947) 80 CA2d 215]; or
- when a tenant is given possession of the property without the payment of rent while negotiations on the lease provisions are still in progress. [**Miller** v. **Smith** (1960) 179 CA2d 114]

## Terminating a tenancy

A landlord's primary concern when terminating a tenancy is the type of notice to vacate he must deliver to establish an unlawful detainer under the different **types of tenancies**, including:

- a *fixed-term tenancy*, in which case the landlord does not need to deliver any notice to vacate prior to commencing a UD action against a holdover tenant after expiration of the lease since the tenancy automatically expires by the terms of the lease [CCP §1161(1)];
- a *periodic tenancy*, in which case the notice to vacate must be for a period at least as long as the interval between scheduled rental payments, but need not exceed 30 days or 60 days, depending on the length of occupancy for a residential tenant [CC §1946];
- a *tenancy-at-sufferance*, in which case the holdover tenant is not entitled to any further notice prior to commencing eviction proceedings since a lease has expired or a periodic tenancy has been terminated by notice [CCP §1161];
- a *tenancy-at-will*, in which case a 30-day or 60-day notice to vacate or otherwise alter the tenancy-at-will is required [CC §789];
- a rent-controlled tenancy of *residential property*, in which case termination of the right to possession is restricted by local ordinances; and
- a *tenancy-at-will in a mobilehome park*, in which case a 60-day written notice is required to be delivered to the tenant. [CC §798.55(b)]

Further, a landlord and tenant by agreement can establish a shorter or lengthier notice period, but not less than seven days. Industrial and commercial tenants typically require three months minimum notice due to the time lost receiving and responding to a notice since it must first go through multiple tiers of corporate management. [CC §1946]

## Changing the type of tenancy

A landlord, by using an improper notice, can end up with a different tenancy relationship from the one he initially conveyed to a tenant. When an existing tenancy is altered, in writing or by conduct, the tenancy may have been converted into another type of tenancy.

A classic example involving a change in the type of tenancy arises when a holdover tenant (a tenancy-at-sufferance) becomes a month-to-month tenant (a periodic tenancy).

A landlord who accepts any rent from a holdover tenant under an expired lease, in payment for a period of occupancy after the lease expired, has elected by his conduct to treat the continuing occupancy as a periodic tenancy. [**Peter Kiewit Sons Co.** v. **Richmond Redevelopment Agency** (1986) 178 CA3d 435]

Thus, a proper notice to vacate, a requisite to a UD eviction, must be served on the holdover tenant who paid rent for the continued occupancy, which was accepted by the landlord. [Colyear, *supra*]

When the tenant holds over after a fixed-term tenancy expires and the landlord accepts rent for the holdover period while the tenant is in possession, the expired lease agreement is *renewed* on the same terms except for the period of occupancy, which is now periodic. [CC §1945]

On expiration of a fixed-term lease, the landlord's continued acceptance of rental payments does not **renew** the tenancy for another term equal to the term of the original lease. Rather, the tenancy is extended as a periodic tenancy for consecutive periods equal to the interval between rent payments — being one month if rent is paid monthly. [CC §1945]

For example, a landlord and tenant agree in writing to a three-year lease with rent paid annually in advance. At the end of the three-year lease, the tenant holds over without further agreement. The tenant tenders an annual rent payment which the landlord accepts.

The landlord's acceptance of rent extends the expired three-year lease for a period of one year since the rent paid was for an annual period. Without a written agreement to the contrary, the tenancy is extended only for the period of the prepaid rent even though the term of the original lease, which controlled the terms of the extended one-year occupancy, was for a three-year period. [**Hagenbuch** v. **Kosky** (1956) 142 CA2d 296]

## Transient occupancies and removals

An occupant of a vacation property, hotel, motel, inn, boardinghouse, lodginghouse, tourist home or similar sleeping accommodation for a period of 30 days or less is classified as a **guest**, also called a *transient occupant*.

A transient guest occupies property known as *lodging, accommodation* or *unit*. The property is not called a rental which is a landlord/tenant characterization of their relationship.

The guest's occupancy of the accommodations contracted for is labeled a *stay*, not possession. During a guest stay in the lodging, the owner or manager of the property is entitled to enter the unit at check-out time even though the guest may not yet have departed.

The contract entered into for the lodging is usually called a **reservation agreement**, but never a rental agreement or lease agreement. [See **first tuesday** Form 593]

Also, guests pay a **daily rate**, not a daily or weekly rent, and they *arrive* at a pre-set date and time for *check-in*, not for commencement of possession. Likewise, guests *depart* at an hour on a date agreed to as the *check-out time*. Unlike a tenant, a guest does not vacate the premises, they check out.

When a guest fails to depart at the scheduled check-out hour on the date agreed, no holdover tenancy is created as occurs under a tenancy for occupancy conveyed by a rental agreement or lease. Thus, a UD action or court involvement is not required to remove the guest. [CC §1940(b)]

However, for the owner or manager to avoid the UD eviction process, the guest, when checking in, must have signed a notice stating:

- the unit is needed at check-out time for another guest who has been promised the unit; and
- if he has not departed at check-out time, the owner or manager may enter, take possession of the guest's property, re-key the doors and clean up the unit for the next guest. [CC §1865; see **first tuesday** Form 593]

To **remove a guest** who fails to timely depart the unit and remains in the unit after a demand has been made to leave, the police can be called in by the manager if his own intervention might cause a breach of the peace, called self-help. The police or the sheriff will assist, without the need for a court order, to remove the guest and prevent a danger to persons or property during the re-keying, removal of possessions and clean up for the arrival of the next guest. [Calif. Penal Code §§602(r); 803.1(a)(3)]

*Transient occupancies* include all occupancies that are taxed as such by local ordinance or could be taxed as such by the city or by the county. Taxwise, the occupancy is considered a *personal privilege*, not a tenancy. Time share units, when occupied by their owners, are not transient occupancies and are not subject to these ordinances and taxes. [Calif. Revenue and Taxation Code §7280]

Transient units do not include *residential hotels* since the occupants of residential hotels treat the dwelling they occupy as their *primary residence*. Also, the occupancy of most individuals in residential hotels is for a period of more than 30 days.

A broker or any other person or entity who manages "vacation rental" occupancies for owners of single-family homes, units in a common interest development (condominium project), units in an apartment complex or any other residence subject to a local transient occupancy tax, must maintain **accounting records**.

Further, the property manager must send a monthly accounting statement to each owner he represents and make the records available for inspection and reproduction by the owner, as well as comply with the transient occupancy tax regarding collection, payment and record keeping. [CC §1864]

# Chapter 10 — License to use land

*This chapter distinguishes a license to use land from a tenant's leasehold and an easement on land. .*

## A personal right to use another's property

The purpose of a *license*, like an easement and a lease, is to grant the right to use property owned by another person. A **license** is similar in this essential purpose to an easement and a lease, yet it is neither.

Similar to an easement or a lease, a license is an agreement. Instead of being placed in writing, a license is often oral. Unlike an easement, a license does not have a perpetual life, nor does it have a specific *expiration date* like a lease.

Also similar to an easement, a property burdened with a license is referred to as the *servient tenement*. Unlike an easement, which benefits the owner of another (adjacent) parcel of real estate, called the *dominant tenement*, and is an appurtenant right transferred with the conveyance of that property, a license has no **dominant tenement** (adjacent property) which benefits from the license. A license is not appurtenant to any property. It is personal, called *in gross*.

Unlike an easement or a lease, a license is a **personal privilege** held by an individual, not an appurtenant right remaining with a property for future owners to use. Since a license is not an appurtenant right and does not benefit a property, the right given by the license cannot be transferred to another individual.

A holder of a license does not typically pay rent for the right to use the burdened property. If consideration for the license exists, it is in the form of an expenditure of time and money by the licensee to improve or maintain the use authorized on the burdened property, such as an irrigation ditch, roadway, fence, etc.

Due to the fact that there is no right to exclusive possession of a burdened property (the **servient tenement**) for an authorized use, a license, like an easement and unlike a lease, permits only the *nonexclusive use* of the property by the licensee.

Unlike either a lease agreement or an easement deed, which are conveyances of an interest in real estate, a license agreement **conveys no interest** in real estate. The right to use a property granted by a license is a mere personal privilege, held by an individual under an agreement with the owner of the burdened property. The license is **revocable** by the owner of the burdened property at any time, unless revocation would be unfair to the holder of the privilege, called a *licensee*.

Typically, a license agreement arises between a property owner and a neighbor or friend as the result of a property owner's acceptance of an informal offer by an individual to jointly or separately make use of the owner's property for a specific activity. The individual given the license generally agrees to maintain or improve the property for the agreed-to use.

## Use of land as a personal privilege

A broker wants to increase the exposure of his business to the public by billboard advertising.

The broker has a friend and business acquaintance who owns vacant property adjacent to a highway. The property owner is willing to allow the broker to place a billboard on his vacant land.

The broker and property owner enter into an oral understanding allowing the broker to put up a billboard for his use only. It is agreed the broker may enter and exit the property at his will to install and maintain the billboard.

A **time limitation** is not specified for maintaining the billboard on the property, nor is any fee or other compensation established. However, the property owner does not relinquish any control over the real estate since he does not give the broker any other right to use the property.

Have the broker and property owner established a landlord/tenant relationship or an easement?

Neither! The broker has only been given a **license** to use the owner's property.

Unlike a landlord/tenant relationship or an easement, a license to use real estate is a **personal privilege**, unattached to any property owned by the broker. Thus, the use is generally non-assignable to others by the broker and, unless agreed to the contrary, is revokable by the property owner at any time.

## A license for non-exclusive use

A license is the **nonexclusive right** given to an individual to use a space or area within a parcel of real estate, or its improvements, that belong to another person. The right to use is held by an individual under an agreement, without the *rights to assign* or to privacy. A license is subject to termination by the owner of the burdened property at will, unless it has become irrevocable.

Consider a property owner who contracts for development work to be done on his property. The owner allows the construction company to store excess dirt on vacant lots he owns until they can haul it away.

While the dirt remains on the vacant lots, an adventurous dirtbiker enters the property and is injured. The injured dirtbiker claims the construction company is a licensee who is not in possession of the real estate and thus is liable for his injuries. The construction company claims they have a *recreational use immunity* since they have an interest in the property as a licensee with a right to use it for the agreed-to purpose.

In this example, the holder of any interest in the property is exempt from liability for injuries to others arising out of their **recreational use** of private property. The property interest exempt from liability can be either possessory or nonpossessory.

Even though a licensee only has a nonpossessory interest in the property, he also has recreational user immunity while the owner remains in possession and control of the land since the licensee has a nonexclusive personal right to also use the property. [Calif. Civil Code §846]

Thus, the construction company is not liable for injuries which occur during the dirtbiker's recreational use of the property since the construction company holds an interest in the property under their license to use.

## License vs. lease and the dominant tenant

A license is often confused with a lease. A **lease** conveys a possessory interest in real estate which allows the tenant to **exclusively occupy** the leased premises in exchange for rent, called a *leasehold estate* or a *lease*. [CC §761]

A **license-to-use** another person's real estate, called a *servient tenement*, is a personal privilege held by an individual. A license is neither personal property nor real property, and it is neither owned by a person nor is it an appurtenance to adjoining real estate. Thus, a license, not being property or capable of ownership, cannot be transferred to the licensee's successors or assignors. [**Beckett** v. **City of Paris Dry Goods Co.** (1939) 14 C2d 633]

Characteristics which distinguish a license from a lease include:

- no writing to formalize the agreement;
- no rental payments;
- no specific location on or within the property where the use will occur;
- no intent to convey a leasehold estate;
- no right to exclude others;
- no termination date; and
- termination at the owner's will, unless the license is irrevocable.

In our previous example, the broker can use his business acquaintance's property to set up his billboard and leave it in place on the property. Also, the broker (or his representative) has the right to go back and forth across the property to maintain or repair the billboard. Thus, the property is a **servient tenement** subject to the terms of the license held by the broker. However, no **dominant tenement** exists since no property benefits from the license; only the broker benefits as the licensee.

Thus, the owner of the property can demand removal of the broker's billboard from the property at any time, and the broker must immediately remove it.

A common thread which runs through both a lease and license is the right to use the property. The glaring distinction between the two is that the license does not include the **right to exclude** any other person from possession as does a lease.

Continuing with our example, the broker cannot fence off, lock out or quarantine in any way the ground under or around his billboard from the property owner or any other person. The license affords the broker no greater right to be on the property than anyone else the owner might allow to concurrently use his property.

## License distinguished from a lease

When an agreement with a property owner gives another person exclusive right to possession of the property against all others, including the owner, it is a lease agreement or periodic rental agreement — a leasehold estate, not a license.

Conversely, when the agreement confers only the privilege to use property which remains under the owner's day-to-day control, it is a license. [**Von Goerlitz** v. **Turner** (1944) 65 CA2d 425]

For example, an owner of a packing company enters into an agreement to purchase raw materials from a wholesale merchant. The wholesale merchant is to supply the packing company with raw materials over a three-year period. In exchange, the packing company will pay the agreed-to price for the materials, as well as allow the wholesale merchant the right to use an unlocked storage unit for temporary stockpiling of his materials and desk space in an office at the packing facility to conduct business.

The agreement does not designate the exact spaces to be used by the merchant. Also, the packing company will concurrently use the same space to be used by the merchant.

Two years into the arrangement, the packing company is sold. The new owner demands the wholesale merchant to move out immediately. The wholesale merchant claims a lease existed between himself and the previous owner, allowing him to remain on the property until the lease expires.

However, no dollar rental amount had been established. Also, the wholesale merchant did not have exclusive possession of the spaces he occupied.

Instead of a lease, the wholesale merchant held a license agreement to use space under which the packing company had a superior possessory right to the premises. Thus, the wholesale merchant's use of unlocked space, concurrently occupied by the original owner, was not a lease.

The mere permission of an owner to let someone use and occupy unidentified space in a structure in a **non-exclusive manner** when the owner retains possession and total control over the premises constitutes a license. [**Caldwell** v. **Gem Packing Co.** (1942) 52 CA2d 80]

### Terms imply a lease exists

The stated intentions in a written agreement between an owner and another person may be to enter into a license agreement. However, the actual language and provisions of the agreement may render it a lease which is improperly titled as a license.

For example, an optometrist enters into a written agreement with an operator of a store to establish an optical department on the premises. The written agreement is entitled a license.

The agreement allows the store to determine the space the optometrist will occupy, set the rent at a percentage of the optometrist's total sales and require the optometrist to make nightly deposits of receipts with the store's cashier. Also, the optometrist has the exclusive right to manage and operate his trade within his space. The agreement prohibits the optometrist from assigning his business and the occupancy to another without the store's consent.

The agreement is for a term of three years, at which time the optometrist agrees to surrender the premises in good condition.

Two years after commencement of the agreement, the store hands the optometrist a notice of cancellation of their agreement (rather than a three-day notice to perform or quit) for his failure to deposit his daily cash receipts with the store cashier.

The optometrist refuses to vacate, claiming he is a tenant of the store under the written agreement. The store contends the agreement was a license, terminable at any time and the optometrist must leave.

However, the terminology in their agreement and the payment of rent is more in line with a lease than a license, indicating the parties created a landlord/tenant relationship by their arrangements.

Similar to a lease, the provision **prohibiting assignment** is only applicable to the ownership of an interest in real estate since a license is non-assumable as nothing is actually owned for the licensee to assign. Also, the optometrist was given **exclusive possession** of a designated space within the store for a fixed period of time which eliminates the owner's right to enter the optometrist's space at any time.

Thus, the arrangement by the content of the written agreement was a lease. The right to exclude others from entry for a stated term, coupled with assignment rights and rent, are characteristics of a landlord/tenant relationship, not a license. [Beckett, *supra*]

If an occupancy agreement contains words or phrases like **lease, rental, demise** or **good tenantable condition**, the agreement will be construed to be a lease rather than a license.

Consider a corporation which owns 150 units in a resort condominium and sells **time-share memberships** in the resort. A member can purchase up to four one-week time share interests.

However, a member is not entitled to reserve any particular unit in advance of occupancy. The assignment of units for actual occupancy during the time period selected is left up to the discretion of the corporation's board of directors.

A restraining order is issued by the Department of Real Estate (DRE) stopping sales of these time-share memberships because a permit and a public report to sell **fractional interests in real estate** was not first obtained from the DRE by the corporation.

The corporation contends the memberships are mere licenses held by the members to use unidentified space and are not a lease or other conveyance of space to the members which would require a permit and public report. The corporation further contends the members do not hold an interest in the real estate since they do not have exclusive right to the possession of any specific unit.

However, the occupancy rights held by the members constitute a lease. The units to be occupied are identical, the duration of occupancy is specific and each member has the right to exclusive occupancy of a unit. [**Cal-Am Corporation** v. **Department of Real Estate** (1980) 104 CA3d 453]

## License recharacterized as a lease

A license is usually oral with very few terms agreed to except the permission to use or conduct an activity on a property while the owner remains in actual possession and retains the right to exclude others, including the licensee. Above all else, a license does not carry with it the right to exclude anyone from the property.

However, with every additional condition agreed to between an owner and user, a license begins to recharacterize itself more and more into a lease.

For example, a broker has an office with unoccupied desks. The broker wants to operate alone and avoid commitments to manage and supervise associate licensees. However, he is willing to share space in the office with other brokers.

The broker offers another broker the use of an office, desk space, a telephone line and secretarial services. The brokers orally agree each will pay their own proportionate share of utilities, secretarial services and rent.

A time period for the use is not specified. The office space selected by the other broker is unlocked and open to the entire office.

In this instance, the original broker may terminate this "rent-a-space" relationship at any time without prior notice or cause since the other broker has been given no more rights than a licensee to use office space.

Conversely, when a broker offers space in his office under a written agreement providing for lockable office space and a specific period for occupancy, the agreement is a lease. With a lease (or a month-to-month rental agreement) in hand, the broker has created a landlord/tenant relationship, not a license.

By specifying more and more terms regarding the right to exclude others — such as the locked door prohibiting entry by others for a period of time — what started out as a mere license to use has been restructured to constitute a lease.

## A license coupled with a lease

On some occasions, a license and a lease co-exist and are held by the same person.

A person can be a tenant with exclusive occupancy to part of the space on the premises of a shopping center and hold a license to use an adjacent portion of the premises as well.

For example, a retail tenant leases space in a shopping center. The tenant has exclusive possession of his store space controlling who may enter. However, the tenant shares use of the sidewalks and parking lots with other shopping center tenants and all the customers of the shopping center.

The tenant has no right to exclusive possession of the sidewalk and parking area, only the space enclosed within his unit. Thus, the tenant holds a license for access and non-exclusive use of the parking area and a lease for the space within the shopping center.

## An irrevocable license

When an individual makes substantial expenditures to improve or maintain his use of another person's property for a long period of time in reliance on his oral agreement with the owner of that property, the license becomes irrevocable and cannot be terminated at will by the property owner.

An **irrevocable license** grants an individual the right to enter and use property as long as the specific activity for which the license was granted is feasible.

For example, a neighbor expends money, or its equivalent in labor, on the on-going maintenance of a road (which provides access from his property to a main road) through property owned by another person. The work is done in reliance on an oral agreement with that property owner. Here, the neighbor by his reliance on an oral agreement when doing the work has an irrevocable license to use the road. [**Cooke** v. **Ramponi** (1952) 38 C2d 282]

Consider the construction of a privacy wall along the entire length of a common property line between adjacent lots. The lots are located on a hillside, one above the other. Each lot is flat with a graded slope between them to adjust for the difference in the elevation. Each lot is improved with a residence.

The boundary between the lots is located at the bottom of the slope. However, for a wall to give the owner of each lot privacy, the wall must be located at the top of the slope, entirely on the uphill parcel and several feet from the boundary line.

The owner of the uphill lot agrees to allow the neighbor below to construct a masonry wall with its foundation on the top of the slope. The owner and the neighbor agree on the height of the wall and that the neighbor may **use the slope** between the wall and the property line.

The owner orally agrees to an easement for the encroachment, which is never reduced to writing so no easement was created.

The neighbor constructs the masonry wall at the top of the slope. He also builds a gazebo within the slope area between the fence and property line.

The owner of the uphill lot sells the property to a buyer. The buyer surveys the lot and demands the neighbor to remove the wall and gazebo since they encroach on what is now the buyer's property.

The neighbor claims he has an irrevocable license to maintain the encroachments and use the slope since he spent considerable time and money to construct the encroaching structure in reliance on the prior owner's oral agreement which allowed him to build the wall and use the top of the slope.

The buyer claims he should not be estopped from revoking the license since he had no notice the license existed and the use was not reduced to an enforceable easement.

However, the license became irrevocable since substantial effort or expenditures were made in reliance on the oral agreement with the property owner allowing the use. Further, the buyer — as a successor owner of the property burdened with the use allowed by the oral license agreement — need not have any knowledge of the irrevocable license to be barred from denying the neighbor's continual use to maintain the existing wall and gazebo under the oral agreement. [**Noronha** v. **Stewart** (1988) 199 CA3d 485]

# Chapter 11 Water rights

*This chapter presents an overview of the rights of landowners and water producers to remove and use surface and ground water.*

## Water is used, not owned

Water is characterized, based on its physical location relative to a parcel of real estate, as belonging in one of two categories:

- *surface water*, consisting of watercourses, lakes, springs, marshes, ponds, sloughs, and any other water flowing over the surface of the earth caused by rain, snow, springs or seepage; or
- *ground water*, consisting of percolating, subterranean bodies of water located in underground *basins*. [Restatement of the Law 2d Torts §§841, 845, 846]

Holders of rights to withdraw **surface waters** are said to have *riparian rights*, and are called *riparian landowners*.

Holders of rights to pump **ground water** are said to have *overlying rights*, and are called *overlying landowners*.

**Legal rights** to extract and use water are based on priorities and are classified as:

- *landowner's rights* consisting of both riparian and overlying rights;
- *appropriative rights* to withdraw water under license from the state; and
- *prescriptive rights* to withdraw water legally entitled to be used by others.

**Riparian rights** refer to a landowner's incidental property right, appurtenant to his property, to withdraw water from an adjacent river or lake for beneficial use on his riparian land.

**Overlying rights** refer to a landowner's right to the use of ground water below the surface of his land. An overlying landowner has rights to an allotment of water which is measured by the ground water in the **basin** over which his land is located. Overlying landowners have equal rights against other overlying landowners to a basin's ground water percolating underneath their land, subject to their *reasonable use* of the water.

Overlying and riparian rights are legally analogous to one another, except for the limitations placed on overlying landowners to use ground water and riparian landowners to use surface water. [**City of Barstow** v. **Mojave Water Agency** (2000) 23 C4th 1224]

A landowner's use of water in the exercise of his riparian or overlying water rights has *priority* over water rights held by appropriators licensed by the state.

Riparian and overlying water rights are part of the ownership of land, and are *appurtenant* to the land and run with the title to the land when it is sold. Water rights are not personal property which can be assigned or used for the benefit of other property.

## Land entitled to water rights

**Riparian land** is a parcel of real estate located both adjacent to a water source with surface water and within the *watershed* (basin) of the surface water.

The amount of frontage in actual contact with the surface water of a river or lake does not determine whether a parcel is considered riparian land. A parcel is considered riparian land if it:

- touches the surface water; or
- was part of a larger riparian parcel and retained its riparian rights by reassignment when parceled.

For example, a 40-acre tract of land, of which only 250 feet abuts a stream, is considered riparian land. [**Joeger** v. **Mt. Shasta Power Corp.** (1932) 214 C 630]

To constitute riparian land, a property must also be located within the **watershed** surrounding the watercourse. Should a portion of riparian land extend outside the watershed, only the portion within the watershed is entitled to use the water from the watercourse.

The logic for the watershed rule limiting the use of surface river or lake water to land located within its watershed is that the water will eventually return to the watercourse, minus the water consumed, in a natural process called *percolation*. Additionally, rain falling on lands within the watershed of a watercourse feeds the watercourse. Thus, a riparian land owner can only divert water to the portion of his land which will allow the water through **percolation** to return to the watercourse.

For example, a tributary enters a creek above the confluence of the creek with a river. An owner of land within the watershed draining into the tributary, but not located within the watershed of the river which the tributary joins, begins to divert water from the river for use in the irrigation of his land.

A riparian land owner who owns land fronting on the river and within the watershed seeks to bar the owner of the land located outside the river's watershed from diverting water.

The owner of the land in the tributary's watershed claims he is entitled to divert water from the river for use on his land since the watershed of the tributary is located within the general watershed of the river.

The riparian landowner claims the owner of the land within the tributary's watershed cannot pump water from the river since the land within the watershed of the tributary is not riparian to the river and the pumping deprives him of his riparian rights.

In this scenario, the owner of the land within the watershed of the tributary is not entitled to divert water from the river. When two bodies of water (tributaries, creeks, rivers) unite, each is considered separate and within separate watersheds.

Land lying within the watershed of one stream above the point where the two streams unite, called a *confluence*, is not considered to be riparian to the other. Further, the surface flow (river) **below the confluence** of two streams is a new and entirely different watershed, justifying a new name for the river below the confluence (as is the practice in Mexico to distinguish the watershed). [**Anaheim Union Water Co.** v. **Fuller** (1907) 150 C 327]

## Riparian rights are appurtenant

The right to use riparian water is an *appurtenant* (incidental) right which is attached to and transferred with the ownership of real estate. [Calif. Civil Code §§658, 662]

Each riparian landowner is entitled to a *reasonable use* of the natural flow of stream water running through or adjacent to his land. However, the quantity of the water withdrawn is subject to an upstream riparian landowner's **priority** right to *first withdraw* water for reasonable use on his upstream riparian land.

Additionally, a riparian landowner cannot divert stream water to nonriparian lands, even if he is entitled to use the water on his riparian land, but does not, since he is subject to the rules of percolation within the watershed. The landowner's riparian right to use the surface water is appurtenant to the land bordering the stream, not other lands which are not bordering the stream. [**Gould** v. **Eaton** (1897) 117 C 539]

## Reasonable use and domestic priorities

Riparian rights are limited by the requirement that water taken from a stream must be put to a **reasonable and beneficial use**. Water is a state resource which, if used under a legal right, must, to the fullest extent possible, be put to reasonable and beneficial use. No one has a protectable interest in the unreasonable use of water. [Calif. Constitution, Article X §2]

Reasonable and beneficial uses include domestic uses and agricultural irrigation. Whether a particular use of water is reasonable and beneficial is determined on a case by case basis. [Calif. Water Code §106]

Consider two landowners with riparian rights to the water in a creek. Both owners use the creek water for domestic purposes. The owner who is upstream begins to divert all of the creek's water with a dam to his riparian land for use in his domestic consumption and agricultural irrigation.

The downstream owner removes the diversion dam and starts to draw water flowing in the creek to his property again. The upstream owner seeks to bar the downstream owner from preventing the diversion of the creek water.

The upstream owner claims his diversion of the creek water may not be prevented by the downstream owner since the upstream owner by his location on the creek has priority and is entitled to first use of the water for domestic and irrigation uses as a riparian owner.

The downstream owner claims he may prevent the diversion of the creek water since the upstream owner's diversion is completely depriving him of his riparian right to the water for domestic use.

In this scenario, the downstream owner is entitled to satisfy his domestic water needs before the upstream owner can use the water for agricultural irrigation. It would be unreasonable for the upstream owner to use water for irrigation before the domestic uses of the downstream owner are satisfied. [**Drake** v. **Tucker** (1919) 43 CA 53]

While riparian landowners hold the same classification of legal rights to water, they must share the water, giving priority to domestic uses over other uses, including agricultural irrigation.

The **sharing** of water between riparian landowners, with priority to upstream owners, is based on a tiered variety of priority and subordinate uses across the entire group of riparian owners, called *correlative rights*. Each landowner holds correlative rights within the riparian class of water rights.

## Water rights are usufructuary

Owners of land and water providers (appropriators) who hold water rights do not legally **own** water. Those with legal rights to water only own rights to the **reasonable use** of the water. Their right-to-use is

**subject to change** when circumstances controlling the use of water change, called *usufructuary rights*, a sort of "here today, gone tomorrow" approach to access and possession.

If a riparian land owner is not using water, downstream riparian land owners are entitled to the full flow of the water, subject to the upstream riparian owner's future reasonable use. Thus, the lack of use of the appurtenant right to water is not lost by mere nonuse alone.

However, an upstream riparian owner who is not using his **allotment of water** may not divert water to nonriparian land since the water would not percolate into the watershed. The upstream riparian owner's right to use the water is appurtenant to the riparian land and does not include any ownership of the water allowing the landowner to transport the water out of the watershed. [Gould, *supra*]

## Competing water rights and allotments

In 1943, California established the **State Water Resources Control Board (Board)**. The Board acts as a referee for all disputes over water rights. As a **referee**, the Board advises the court on the appropriate water allotment each of the disputing parties is entitled to take. Also, on a request from holders of water rights, the board itself may hear legitimate disputes between the parties to determine the water allotment each party is entitled to take. [Wat C §§2000, 2501]

When the Board determines the allotment of water to each holder of riparian rights, the needs of all riparian landowners (within the watershed) are taken into account since riparian rights in water are *correlative*. The amount of water allocated to a riparian owner is determined case by case based on, among other factors, the need for domestic use, irrigation and generating power.

For an example which applies to **correlative rights**, an upstream owner of 66 acres of riparian land suitable for profitable irrigation, a reasonable riparian need, is entitled to a smaller proportion of the water from a watercourse running through his land than a downstream owner of 96 acres of riparian land also suitable for profitable irrigation. [**Half Moon Bay Land Co.** v. **Cowell** (1916) 173 C 543]

## Riparian rights not lost by disuse

An owner of riparian land has water rights which are "part and parcel" of his land, called *appurtenant rights*. As an **appurtenant right**, riparian water rights cannot be lost by disuse.

For example, co-owners of riparian land partition the land, providing each with separate ownership of a pro rata portion. The partition is made by deeds which grant each owner his pro rata share of the original parcel's riparian right to the stream flow running through the parcels. Concurrently, the co-owner receiving the southern (baja) parcel is given an easement across the northern (central) parcel to construct a pipeline to divert his share of the water from the stream to his parcel.

The southern owner never builds the pipeline and never diverts the water. Later, the northern owner begins to divert all the water from the stream to his parcel above (alta) the point where the pipeline easement meets the stream.

The southern owner claims the northern owner cannot divert all the water from the stream since, as a riparian owner, the southern owner is entitled to his pro rata share of the stream's flow, whether or not he uses his share.

The northern owner claims he can divert all of the stream water since the rights of the southern owner to divert the water were contingent on the construction of the pipeline and the diversion of the water, which was never done.

However, the northern owner cannot interfere with the southern owner's riparian right to his reasonable share of the stream's flow. The riparian rights of the southern owner are "part and parcel" of his land, an appurtenant right which cannot be lost by disuse alone. The pipeline easement also cannot be lost by disuse alone. [**Parker** v. **Swett** (1922) 188 C 474]

Consider two appropriators who have no riparian rights appurtenant to any land but are allowed to withdraw water up to a set amount in the river. Additionally, both appropriators are entitled to take water unused by senior appropriators.

The senior appropriator fails to take his entitled amount of unused water during a five-year period. The junior appropriator seeks to reduce the amount of the senior appropriator's entitlement to the amount actually used each month during the prior five years, claiming the senior appropriator's nonuse forfeited the unused portion of his entitlement.

The senior appropriator claims he did not forfeit his right by nonuse since the amount of unused water available is unpredictable and therefore can not be forfeited. Did the senior appropriator forfeit the unused portion of his entitlement to unused water?

Yes! The senior appropriator's nonuse forfeited his right to take unused water, entitling the junior appropriator to take the unused water up to the amount of his entitlement. [**North Kern Water Storage District** v. **Ken Delta Water District** (2007) 146 CA4th 555]

### Public dedication by allowing use

A riparian landowner diverts water from a river for public use. The water diversion adversely affects the water rights of another riparian landowner. However, the other riparian landowner allows the interference to continue unabated. In this situation, the **conduct** of the adversely affected landowner causes his riparian rights to be *dedicated* to the public use. Once **dedicated**, the landowner can only seek compensation for the loss of his riparian rights and cannot get his rights back.

For example, a downstream riparian owner constructs a canal to divert a large portion of a river's flow. The water is diverted for the domestic and irrigation uses of towns which were established and grew in reliance on the diverted water. The extent of the diversion is known to an upstream owner who allows the diversion to continue uninterrupted for several years.

Later, the upstream owner begins to take water from the river for irrigation of his lands, diminishing the amount of water available for the public use. The downstream owner seeks to bar the upstream owner from diverting the water, claiming the diversion upstream now deprives the downstream riparian owner of the water he was accustomed to diverting for the public use.

The upstream riparian owner claims he is entitled to divert the water for irrigation of his riparian lands since, as a riparian owner, he is entitled to use a reasonable share of the river water.

The downstream riparian owner claims the upstream riparian owner is not entitled to divert water for irrigation since the water taken by the downstream owner is devoted to public use in reliance on the upstream owner's disuse.

In this instance, the upstream riparian owner may not now interfere with the downstream diversion of water. The diversion of water for public use was allowed to continue unchecked for a period of years. This non-interference conduct constituted a dedication of the upstream owner's water rights to public

use. The upstream riparian owner's only recourse is to seek compensation for his lost riparian rights from the downstream owner. [**Miller & Lux** v. **Enterprise Canal & Land Co.** (1915) 169 C 415]

## Termination of riparian rights

Consider riparian land fronting on a river or lake which is subdivided or parceled. One of the parcels created has no frontage on the watercourse. The parcel is later conveyed without a provision in the deed transferring the riparian rights.

In this example, the parcel conveyed without reference to its riparian rights loses its riparian land status forever. The parcel remains nonriparian even when the parcels which made up the original riparian parcel are later brought together under one ownership.

For example, a riparian tract of land is subdivided into parcels. A parcel without frontage on the watercourse running through the original tract is conveyed to a buyer without conveying the riparian rights which were appurtenant to the original tract.

The buyer later sells the parcel which has no frontage on the watercourse to the owner of an adjoining parcel which was a part of the original tract and has frontage on the watercourse. The owner then begins to irrigate the newly acquired parcel with water from the watercourse.

A downstream riparian owner seeks to bar the upstream owner from irrigating the adjoining nonriparian parcel since the adjoining parcel was conveyed out of a riparian tract without an accompanying transfer of riparian rights.

In this scenario, the upstream riparian landowner is not entitled to irrigate the adjoining, nonriparian parcel with water from the watercourse. The conveyance of a parcel, severed from a larger parcel which has riparian rights, terminates the conveyed parcel's riparian rights unless the rights are transferred by the deed which severed the parcel. Even if the severed parcel is eventually conveyed to waterfront owners of portions of the original riparian tract, the severed parcel's status remains nonriparian. [Anaheim Union Water Co., *supra*]

## Appropriation by non-riparian owners

The right to the use of water located within the state of California may be acquired by *appropriation*. [Wat C §102]

A person who diverts water from surface or ground waters without possessing riparian or overlying rights to the water he is diverting is called an *appropriator*.

Waters flowing underground or surface waters flowing in natural channels in excess of the entitlement of riparian, overlying and previously appropriated water rights are considered the **public water of the State of California**. These excess waters are subject to appropriation by anyone. [Wat C §1201]

## Appropriation permit process

The first step in appropriating water is to apply for a **permit** from the State Water Resources Control Board (Board). [Wat C §1250 et seq.]

The application for the permit must include the following information:

- the name and address of the applicant;

- the source of the water supply to be appropriated;
- the nature and the amount of the proposed use of the appropriated water;
- the location of any proposed ditches, canals or other works being constructed;
- the date of commencement of any construction works;
- the date of completion of any construction works;
- the proposed place of the water diversion;
- the location where the diverted water is to be used;
- the time for the complete application of the appropriated water to the proposed use;
- information about the affect the appropriation would have on native fish and wildlife, along with a statement of any measures which would be taken to protect fish and wildlife during the process of appropriation; and
- information to demonstrate that unappropriated water is available for the proposed use. [Wat C §1260]

Next, the district attorney and the board of supervisors for the county where the appropriation will take place are notified of the diversion. The public is notified of the appropriation by postings throughout the county where the diversion will take place. [Wat C §§1300, 1301, 1320]

If the proposed appropriation is more than three cubic feet per second or 200 acre-feet per year of storage, the appropriator must publish a notice of application in a newspaper in the county where the diversion will take place. [Wat C §1310 et seq.]

Any person interested in protesting the proposed appropriation may file a written protest against the diversion with the Board. [Wat C §1330]

When deciding whether to issue the permit for appropriation, the Board will consider if the proposed use is the best use for the water in relation to other uses such as:

- domestic use or irrigation;
- preservation and enhancement of fish and wildlife;
- recreational purposes;
- municipal purposes;
- mining and power purposes; or
- use in any water quality control plan. [Wat C §1257]

On the approval of an application for an appropriation permit by the Board, the permit is issued granting the appropriator the right to use water only to the extent and for the purpose described in the permit. [Wat C §1381]

The construction of the diversion and the use of water as specified in the permit must be performed with due diligence or the appropriation permit may be revoked. [Wat C §§1396, 1410]

### Licensing the appropriation

Once the construction of a diversion under a permit issued by the State Water Resources Control Board (Board) has been completed, the Board issues the appropriator a license for the continued use of the water specified in the permit. [Wat C §§1600 et seq.]

The license to appropriate water is effective for as long as the appropriated water is needed for the beneficial use stated in the permit. [Wat C § 1627]

## Rights of appropriator against others

An appropriator's rights against other appropriators are based on the "first in time, first in right" theory. Thus, prior appropriators may divert all the water allotted for use under their permit before later appropriators may divert water, a tiered condition called *priority*. [CC §1414]

The excess water previously allotted to later (junior) appropriators may not now exist after prior (senior) appropriators take their allotment, leaving no water to be taken by junior appropriators. Correlative rights to a parity share do not exist among appropriators since they are not riparian or overlying landowners.

Additionally, landowners possessing riparian and overlying rights have water rights with are superior to the rights of appropriators, called *priority rights*. Appropriators may only appropriate water which is not presently being used by a riparian or overlying landowner and has not already been appropriated by anyone else, called *surplus water*.

In the event of a water shortage, appropriators must yield to riparian and overlying landowners since landowners have priority rights to divert or pump water. These rights are appurtenant to their property. [City of Barstow, *supra*]

When a person licensed to appropriate water fails to use the water for a period of five years, his appropriative rights terminate and the water allocated to the appropriator reverts back to the public. Once the water reverts to the public, it is once again regarded as unappropriated. [Water C §1241]

## Prescriptive rights by converting water

*Prescriptive rights* to the use of water can be established when a person wrongfully appropriates non-surplus water **openly and adversely** for a uninterrupted period of five years, and does so without documentation or evidence of a legal right, called a *claim of right*. Essentially, an adverse user is *converting* water, which riparian or overlying landowners have the right to withdraw, to his use without a good faith belief he holds any legal rights to its use.

Riparian and overlying owners may interrupt anyone trying to obtain prescriptive rights by continuing to use their allotment of water. Holders of riparian and overlying rights lose priority to those who obtain prescriptive rights to water, since their water rights have been lost to the extent taken by prescription. [City of Barstow, *supra*]

For example, an upstream riparian owner builds a dam which stops the flow of a stream to a downstream riparian owner. The downstream riparian owner is aware of the dam and allows the upstream owner to divert the flow of the stream for over five years.

Later, the downstream riparian owner seeks to stop the upstream riparian owner from diverting the flow of the stream, claiming he is entitled to a portion of the stream's flow since he is a riparian owner.

The upstream riparian owner claims the downstream riparian owner cannot now stop him from diverting the stream since he has been openly and adversely diverting the water for over five years and now holds prescriptive rights in the water which cannot be taken from him.

In this situation, the downstream riparian owner cannot stop the upstream riparian owner from diverting the stream. The upstream riparian owner has been adversely diverting the water with the downstream riparian owner's knowledge for over five years. Thus, the upstream riparian owner now has prescriptive rights in the water which are superior to the riparian rights of the downstream riparian owner. [**Sibbett** v. **Babcock** (1954) 124 CA2d 567]

Prescriptive rights, like appropriative rights, may also be lost by abandonment after five years. [CC §811]

## Regulation of water rights by Board

The state government regulates the use of water in California when disputes arise between riparian/overlying landowners and appropriators.

Riparian, overlying and appropriation rights are subject to the state's interest in conserving and regulating water use. [Wat C §101]

The state government, under its State Water Resources Control Board (Board), controls unclaimed water rights and partitions water for the highest and most beneficial use.

The Board determines the respective water rights of individuals and makes decisions by weighing the public interest versus the needs of individuals. [Wat C §2501]

Consider a city whose water supply is experiencing a shortage since the underground water basin is being overdrawn. A resolution is adopted by the city calling for those landowners and appropriators who agree to be bound by the solution to give up their water rights in exchange for an allotment of water. Each user agreeing to the allotment is given an amount he can pump without charge. The amount of the allotment is based on the highest quantity of water the user consumed annually during the last five years. A fee will be charged to pay for the purchase and replacement of water used beyond the allotted amount.

Additionally, the terms of the resolution are imposed on all landowners with overlying water rights even if they do not agree to the resolution, thus eliminating their priority water rights.

An overlying landowner subjected to the resolution claims a taking of his priority water rights has occurred without compensation since the city's allocation solution elevates the rights of appropriators and those without any water rights to the status of riparian owners.

The city claims placing the owner under the city's water resolution is not a taking since the state Constitution requires the water supply to be made available to the largest number of users the water supply can reasonably support.

However, placing the overlying landowner under the city's water resolution does constitute a **taking**. The city can impose a water resolution to achieve a practical allocation of water among those with competing interests in the water. However, the city's resolution may not ignore priority rights of overlying landowners who assert them, change priorities among the class of holders of water rights, nor eliminate vested water rights. Thus, the overlying landowners have priority over appropriators to the ground water and can pump to satisfy their domestic and agricultural irrigation needs which are reasonable and beneficial. [City of Barstow, *supra*]

# Chapter 12 Navigable waters in public trust

*This chapter looks into the multiple purposes of the public trust and the powers the state holds as trustee to regulate and control property subject to the public trust.*

## For the use and benefit of the people

**Navigable waterways** are held in a *public trust* by the State of California as trustee for the use and benefit of the people for navigation, commerce, fishing, recreation and retention of its natural condition. [Calif. Constitution, Article X §4]

**Title** to the land under navigable waters within the borders of California is vested in the state as *trustee* of the public trust. California acquired title to the lands as trustee when it was admitted to the Union in 1850 under the *equal footing doctrine*. [Calif. Civil Code §670]

Although title to the lands beneath navigable waters is held by California as trustee, navigable waterways and the right of access to navigable waters are subject to a superior *federal navigation servitude* — an easement — reserved by the federal government on establishing California as a state in the Union. [**Gibson** v. **United States** (1897) 166 US 272]

The **federal navigation servitude** can only be exercised to aid navigation and is grounded in the commerce clause of the United States Constitution. It is not grounded in the ownership of navigable waterways which is held by the State of California. [United States Constitution, Article I §8, clause 3]

Although the state's power to manage its navigable waters is subject to the federal government's exercise of its navigation servitude easement, the state can **regulate and control** waters and lands held in the public trust in any manner consistent with the improvement of commerce, navigation, and other public trust interests.

California's right to regulate public waterways extends to property outside the public trust lands.

## Property subject to the public trust

Navigable waterways, in addition to tidelands, shore zones and nonnavigable tributaries of navigable waters, are all subject to state regulation and control for purposes of the public trust.

Navigable waterways are owned by the state as trustee of the public trust and include waterways which were used or were susceptible to use in their ordinary condition as a highway for commerce (trade or travel). [Calif. Harbors and Navigation Code §100]

However, waterways **created after** California's 1850 admission to the Union, either natural or by man-made, are not vested in the state. However, if these post-1850 waterways are navigable, they are subject to regulation and control by the state under the public trust.

A privately owned waterway is considered navigable if, in its ordinary condition, the waterway affords a channel for useful commerce and navigation. Thus, the private ownership is limited in its use of the property.

For example, an owner's land is permanently flooded by a river when a nearby levee breaks.

The general public begins using the waters over the property owner's land for boating, commercial transportation and other public trust uses, by entering and leaving the flooded property through the breaks in the levee.

The property owner attempts to bar access to the waters over his land claiming the waterway is not navigable and thus not subject to the public trust since the waterway is only three to seven feet deep in most places and does not contain a clearly defined channel.

The boating public seeks to restrain the owner from interfering with boating on his property since rowboats and small skiffs frequently navigate the property owner's waterway.

Are the waters covering the property owner's land navigable and therefore subject to the public trust?

Yes! The waterway is navigable since it is available for use by the public. **Navigability** does not depend on the type of commercial or recreational use the property is susceptible to, or the difficulty in navigating the waterway. Thus, the owner's flooded property is subject to regulation and control by the state as part of the public trust and the owner cannot bar public access to the water even though he holds title to the underlying land as a private property owner. [**Bohn** v. **Albertson** (1951) 107 CA2d 738]

Additionally, *tideland* is considered public trust property vested in the state as trustee. **Tideland** is all land located between the mean low tide mark and the mean high tide mark of property subject, respectively, to the ebb and flow of the tide from an ocean or sea. [CC §670]

Privately owned *shore zone* property also falls under the control of the public trust. **Shore zone** property is all land located between the low water mark and the high water mark of navigable nontidal waterways, including rivers and lakes. Shore zone land is subject to management by the state for purposes of the public trust. [**State** v. **Superior Court of Lake County** (1981) 29 C3d 210]

Although a landowner retains title to the shore zone, all of the practical incidents of use and ownership are reserved to the public. The owner holds a *nonexclusive right* to use the **shore zone** consistent with the public's use of the property for purposes allowed by the public trust.

### Nonnavigable rivers controlled as tributaries

Nonnavigable waterways are not technically subject to the public trust. However, the public trust regulation and control of navigable waters of necessity must regulate the obstruction, extraction of water and the dumping of debris into **nonnavigable tributaries** which feed into navigable waterways. These activities interfere with navigation, recreation or preservation — trust purposes — of downstream navigable waterways.

For example, an owner of a hydraulic mine dumps and discharges debris composed mostly of sand, gravel and boulders into a nonnavigable stream which empties into a downstream navigable river, a process called *placer mining*.

Due to the impact on the stream, the mining debris raises the bed of the downstream navigable river, thus impairing its navigability.

The state, in the name of the people, seeks to permanently enjoin the owner of the hydraulic mining operation from dumping debris into the stream, claiming the dumping is an invasion of the rights of the public to navigate the river.

The mine owner claims the public cannot stop him from dumping debris into the stream since the stream is nonnavigable and therefore not subject to state regulation and control under the public trust.

Can the mine owner continue to dump debris into the nonnavigable stream?

No! The owner of the placer mining operation is barred from dumping and washing debris into the non-navigable stream since its waters, along with the debris, flows into and adversely affects the public use of a navigable river which is subject to state regulation and control under the public trust. [**People** v. **Gold Run Ditch & Mining Co.** (1884) 66 C 138]

### Property not subject to the public trust

The title of much privately owned property is derived from an original *Mexican land grants* issued under Mexico or the Law of the Indies before 1848. If a land grant was later confirmed by issuance of a *federal patent* (deed) and did not *reserve waterway rights*, the property is not subject to regulation and control by California for purposes of the public trust.

For example, an owner holds fee title to land under a navigable waterway which became part of the United States following the Mexican War of 1848.

The predecessors-in-interest of the current landowner had their pre-war interest in the waterway confirmed in a federal patent (deed) issued after California attained statehood in 1850. However, the patent was issued under federal legislation which implemented the Treaty of Guadalupe Hidalgo (signed in 1848). The legislation, as mandated by the treaty, validated claims to lands in California based on Mexican law.

At the time ownership was confirmed by the federal patent (deed), California was considered a state. However, California did not assert a public trust interest in the waterway at the confirmation hearing (in federal court) determining the land grant ownership. Thus, no reservation for the public trust was made in the patent (deed) issued by the federal government on confirmation of ownership.

The state now seeks to subject the landowner's waterway to the state's control under the public trust since all navigable waterways were previously transferred to the state as part of the public trust when California was admitted into the Union in 1850, leaving no waterway ownership to be later confirmed or conveyed by federal patent (deed).

The landowner claims the state cannot now assert a public trust interest in his property since his interest was previously confirmed without any mention of the public trust.

Is the property subject to the public trust?

No! Under most circumstances, tidelands located within the state cannot be conveyed to a private individual by a federal patent (deed) since the United States previously conveyed all tidelands in trust to the state on its admission to the Union.

However, property subject to confirmation of ownership and issuance of a federal patent (deed) under the Treaty of Guadalupe Hidalgo in 1848 was *reserved* to the United States at the time California was admitted to the Union in 1850. For the United States to discharge its international duty to Mexico under the treaty with respect to the conveyance of tidelands to land grant owners, the reservation was mandated since tidelands were not owned by the government under Mexican law. [**Summa Corp.** v. **California** (1984) 466 US 198]

## The public trust has purpose

The objectives of the public trust have evolved with the changing public perception of the values and uses of waterways.

Traditionally, the uses of land and water held or subject to public trust regulation encompassed navigation, commerce and fishing. However, the definition of public uses to which waterways, tidelands and shore zones are subject is sufficiently flexible to encompass changing public needs.

**Recreational uses** by the public, such as boating or fishing and the retention of waters and lands in their natural state, are also counted as being public rights protected in waterways and lands owned or controlled by the public trust. California, as trustee, has a duty to protect the people's common heritage of waterways, lakes and tidelands within the ownership or control of the public trust.

For example, one of the most important public uses of the tidelands, due to current public recognition, is the **preservation of tidelands** in their **natural state**. Preserved, the tidelands serve as ecological properties for scientific study, open space for public enjoyment and wildlife environments which favorably affect the native species, scenery and climate of the area. [**Marks** v. **Whitney** (1971) 6 C3d 251]

## Powers of the state as trustee

Some management powers the state possesses to regulate and control the use of properties owned or subject to the public trust include the right to:

- grant rights and convey public trust property to private parties;
- revoke those same rights and conveyances;
- destroy the navigability of certain waters for the benefit of others;
- control nonnavigable tributaries which feed into navigable waterways;
- build structures across or along waterways; and
- deepen or change the channels of waterways.

The state may also order the removal of an owner's improvements from public trust property at any time, even if the improvements have been erected under license or consent from the state, a condition called *usufructuary*. To order the removal, the improvements must substantially interfere with navigation or commerce, such as machinery for the prospecting of oil and gas which hinders water traffic and local fisheries, or be encroachments upon public rights or the appropriation to private use of uses which belong to the public, called *purprestures*. [**Boone** v. **Kingsbury** (1928) 206 C 148]

In short, the state, as trustee and owner of all navigable waters and the lands beneath them, has the power to use those waterways and the lands subject to the public trust in any manner consistent with the purposes of the trust.

However, the state's power as trustee over navigable waters and the lands under them cannot be abdicated to other governmental agencies. Trust powers may be **delegated** to a municipality or other governmental body, but the state always retains the right to revoke those powers at any time and exercise them itself. Thus, the lands under navigable waterways cannot be placed entirely beyond the (usufructuary) direction and control of the state. [**Illinois Central Railroad Company** v. **People of the State of Illinois** (1892) 146 US 387]

## Conveying public trust property

The state, as the manager of lands subject to the public trust, has the right to transfer ownership of public trust property to a **private party**. Additionally, the state has the power to revoke previously granted rights in public trust property at any time, thus exercising the **usufructuary** aspect of property rights.

While conveying ownership, the state cannot completely convey away the public's right to the use of the navigable waters flowing over the land conveyed. [Gold Run Ditch & Mining Co., *supra*]

Accordingly, any conveyance of public trust property to an individual is subject to the public's rights under the public trust.

However, the state as trustee has the authority to convey absolute title to land under navigable waters to private persons only if the purpose of the conveyance is to promote navigation, commerce or other public trust purposes. [Illinois Central Railroad Company, *supra*]

In this respect, even grants of absolute fee title to private parties of trust property still serve the public interest. However, such grants to private parties, even if made for public trust purposes, do not vest absolute title in a private party until the improvements called for by the state to enhance the public use for trust purposes are actually completed.

For example, the state dedicates a navigable canal, held as public trust property, to a city for public use as a free dock for ships. As part of the dedication, the state requires the city to deepen the waterway and extend streets and drawbridges over the canal to improve the public trust purposes of navigation and commerce.

The city does not make the improvements required by the state.

The state then revokes the dedication of the canal claiming it has the right under the public trust to revoke the dedication since the city did not complete the improvements.

The city claims the state cannot revoke the dedication and reclaim jurisdiction over the canal since the waterway has already been dedicated to the city to hold and use for the purposes of the trust.

Can the state revoke its dedication of the canal to the city?

Yes! The dedication of the canal to the city for the purpose of deepening and improving the waterway was only an offer to dedicate conditioned on the city building the improvements. The state had the right to withdraw the offer in whole or in part at any time prior to the city's acceptance of the canal by completing the improvements. Until acceptance, the dedication was not complete since the public did not get to use the canal in the manner intended by the state as trustee of the property. [**People** v. **Williams** (1884) 64 C 498]

## Compensation for a public trust taking

If the state retakes title to public trust property previously conveyed to a private party, the party must be compensated for the taking. Compensation must also be paid to a private property owner when the state erects improvements which are **permanent physical encroachments** on privately owned property which is not subject to regulation or control by the public trust.

However, the state may, without compensation, erect improvements to aid navigability or other public trust purposes on state owned public trust property and private properties which are under navigable waters held in public trust.

For example, a property owner operates a beach resort on land fronting on a navigable bay.

The state uses its public trust powers to construct a permanent breakwater in the bay near the resort owner's property to create a harbor for pleasure yachts and fishing boats.

However, the breakwater stops the normal flow of sand carried to the beach, causing the gradual *erosion* of all of the sandy beach on the resort owner's property.

The resort owner claims the state has taken his property by **inverse condemnation** since the erection of the breakwater resulted in a taking of his property for public use due to the erosion of his shoreline.

The state claims it does not owe the resort owner compensation for any damage to his shoreline on the bay, called *littoral rights*, caused by the erection of the breakwater since the resort owner's **littoral right** to enjoy sandy accretions is not perpetual and is always subordinate to the state's right to improve navigation for purposes of the public trust.

Does the state owe the resort owner compensation for taking his shoreline property?

No! The damage to the resort owner's property due to the loss of the sandy shoreline was an incidental consequence of the state's management (as trustee) of navigable waterways and not a taking by inverse condemnation. The state did not owe the resort owner compensation since the breakwater constructed by the state was not a direct physical encroachment on the resort owner's property.

Through the exercise of its public trust powers, the state always has the **right to impair** rights appurtenant to property fronting on navigable waters, called *riparian property* if it banks on a river or stream, or *littoral property* if it banks on the shore of a lake, bay, sea or ocean. [**Miramar Co.** v. **City of Santa Barbara** (1943) 23 C2d 170]

### Usufructuary licenses for appropriation of water

The state, acting through the State Water Resources Board (Board), may permit an individual, called an *appropriator*, to take water, a process called *appropriation*, under a *usufructuary license* which is retrievable by the state without compensation. Usufructuary licenses may be granted even though the appropriation may unavoidably harm public trust uses. [Calif. Water Code §104]

However, the Board, while planning and allocating water resources within the state, is required to take public trust interests into account. [Wat C §§1243, 1257]

Accordingly, when granting the **usufructuary right** to take water, the Board must consider the effect such diversions will have on the public trust's interest in navigable water and reasonably attempt, as far as feasible, to avoid or minimize any harm to those interests.

After the Board has approved the appropriation of water by an individual, the state has a duty to continue its supervision over the appropriator's removal and use of the appropriated water. In exercising its public trust powers to manage navigable waters, the state is not bound by past allocation decisions which may now be wrong in light of current knowledge or current needs.

For example, a river is the only supply of water flowing into a navigable lake subject to control and management under the public trust.

The Board grants a usufructuary license to a city to divert the entire flow of the river for domestic use without considering the diversion's effect on the public's interests in the lake.

As a result of the diversion, the water level of the lake drops significantly, diminishing the lake's economic, recreational and scenic value.

The people of the state ask the Board to review the city's appropriation of water from the river claiming the diversion is harming interests protected by the public trust.

The city claims its right to divert water from the river is superior to the public's rights under the public trust since the use of water for domestic purposes is the highest use of water.

Can the Board review its past allocation decision and modify the city's diversion of water to take into account public trust interests?

Yes! The state may **review and revoke** water use licenses at any time using its usufructuary rights, as the state's supervisory authority bars any party from claiming a vested right to divert water once it becomes clear that such diversion significantly harms interests in navigable waters protected by the public trust. [**National Audubon Society** v. **Superior Court of Alpine County** (1983) 33 C3d 419]

# Chapter 13 Boundary disputes

*This chapter applies the agreed-boundary doctrine as a method of settling boundary disputes.*

## Doctrine of agreed boundaries

A parcel of real estate is divided into two equally sized parcels by a recorded survey. Later, a fence is erected between the two that is not located on the common boundary line. Thus, one parcel appears to be physically larger than the other.

The owner of the parcel which appears smaller (that has the fence located on it within its boundary) sells his parcel. The new owner hires a surveyor to determine the location of the boundary between the properties.

The survey sets the boundary at the location described in recorded documents. The survey shows the fence is not located on the legally described boundary between the adjacent properties.

The owner of the smaller parcel seeks to recover possession of the strip of land located on the other side of the fence, within his legal description, by removing the fence.

The neighboring owner of the larger parcel claims the fence is the agreed boundary since the fence has stood for so many years that it is reasonable to infer the previous owners agreed the location of the fence to be their common boundary.

The owner of the smaller parcel claims the *agreed-boundary doctrine* does not apply since a recorded legal description of the boundary is available and the true boundary can be located.

Is the owner of the smaller parcel correct in relying on the legal description of the property to establish the actual boundary location?

Yes! The doctrine of title by agreed boundaries, commonly referred to as the **agreed-boundary doctrine**, does not apply since:

- the exact boundary location can be readily located; and
- the owner of the larger parcel defending the fence as the boundary cannot show the prior owners were **uncertain** as to the true boundary description and then, to resolve their uncertainties of location, **agreed** the fence would mark the boundary. [**Bryant** v. **Blevins** (1994) 9 C4th 47]

## Elements of the ancient doctrine

To establish a boundary line under the *agreed-boundary doctrine*, the following facts must exist:

- **uncertainty** as to the boundary's exact location;
- an **agreement** between the owners to set the boundary line; and
- **acquiescence** to the boundary line for a period of at least five years; or
- a **substantial loss** would be suffered due to a change in the location of the boundary line to the legally described location. [**Ernie** v. **Trinity Lutheran Church** (1959) 51 C2d 702]

The **agreed-boundary doctrine** developed during a time when less advanced surveying techniques, or lack of surveyors or monuments, made it too difficult or expensive to locate the boundary line described in the deeds.

Thus, the more practical way to set a boundary line in rural and relatively unpopulated areas with lower land values was often for owners of adjacent parcels to agree between themselves on the location of a common marker, such as a fence, to set the agreed boundary.

However, surveying techniques have significantly improved. Now, if a deed is clear and a competent surveyor is available, the true boundary line can easily be established to eliminate the uncertainty of the boundary's location. Thus, the ancient agreed-boundary doctrine has been reduced to the status of a legal last resort.

In the absence of an oral or written agreement between an owner and his neighbor to set the boundary line at some place other than a well-surveyed and documented deed line, the boundary line described in their deeds remains as the boundary. [**Armitage** v. **Decker** (1990) 218 CA3d 887]

## Agreeing to the boundary

Once owners of adjacent properties uncertain over the true boundary actually agree to establish the location of their common lot line, the location they set will replace the legal line, regardless of how inaccurate it is, provided either the five-year statute of limitations runs or substantial loss would result from the boundary line being moved to the legally described location.

For example, two neighbors own adjacent parcels of real estate and each farm their respective parcels.

When their real estate was originally surveyed decades earlier, the federal government placed a five-inch section post to mark the boundary line. The neighbors search but cannot locate the section post to help them set their property lines. Instead of surveying their parcels, they mutually erect a fence intending it to set the boundary between their properties.

The fence is eventually taken down, but the owners continue to farm up to the spot where the fence had been located.

Over five years later, each owner sells their respective property to different buyers. The new buyers continue to farm their parcels within the parameters set by the original owners.

Later, one of the new owners surveys his parcel, locates the federally placed post and marks the legally described property line. The location of the post reveals the owner's neighbor has been farming 2½ acres on his side of the property line described in the public records.

The owner sues to quiet title to the 2½ acres and reclaim possession. The neighbor claims the fence line became the boundary line when the original owners set the fence as the property line between the adjacent parcels.

Is the fence line the true boundary line?

Yes! When the owners of adjacent real estate are **uncertain** where their boundary is located, they can agree to set a new boundary line. Further, the **agreed-to boundary** which remains in place for more than five years is binding on subsequent owners even though the recorded legal description is different. [**Joaquin** v. **Shiloh Orchards** (1978) 84 CA3d 192]

## Uncertain boundaries

Uncertainty over the exact location of a boundary line may arise in a number of circumstances.

For example, where natural markers, such as trees, boulders or a creek, were used to mark a beginning or ending point for a boundary line, the location of the markers may have changed or the markers may have disappeared over time.

Section posts and other surveyor's monuments which indicate boundary lines are also subject to earth movement, climatic changes and human activity. Also, the legal descriptions for parcels of real estate may be conflicting or simply fail to correctly set a boundary line, or the descriptions do not coincide with another line or boundary.

An actual dispute over a boundary's location need not exist between the owners of adjacent parcels. Instead, owners must merely be in doubt over the location of the true boundary and agree to the location of the boundary when they set it.

Usually, it is not the original owners who squabble over title or possession based on the agreed-to boundary line, it is the later owners.

However, when the boundary line in a recorded deed is readily ascertainable by a surveyor, the description in the record controls, unless the landowner defending the location of the line as the common boundary provides cogent proof the boundary line as located settles an actual, not implied, boundary dispute. [Bryant, *supra*]

## Agreement to make certain

An agreement to mark a boundary line may be oral, written or result from the conduct of neighboring property owners. Oral or written agreements on the boundary's location are called *express agreements* since they are not implied.

**Written expressions** are best since they formally document the mutual intentions of the owners. However, they usually exist only in the case of a lot line adjustment map.

Unlike the conveyance of real estate, owners do not have to put their boundary agreement in writing for it to be enforceable. With the setting of an agreed boundary, neither owner is conveying real estate to the other. Instead, the owners are agreeing to what land constitutes their own property. [Ernie, *supra*]

## The element of duration

Owners must acquiesce to the agreed boundary for a period of at least five years, the *statute of limitations* for the recovery of real estate. [Calif. Code of Civil Procedure §318]

The statute of limitations requires the adjacent owners to resolve a dispute within the five-year period. If disputes are not settled within this period, the claims are put to rest. Thus, an owner who fails to object to a boundary line during the statute of limitations period is presumed to have agreed to the boundary set by the adjacent property owner.

However, an agreed boundary can be established even if the **five-year period** has not run. An exception to the five-year rule arises if substantial loss will be caused by the movement of the agreed boundary to the true lot line.

For example, when an adjacent owner builds improvements near the line established in reliance on an agreement that it is the boundary, the new boundary will be allowed without the enforcement of the five-year period. However, the new boundary will only be allowed if the adjacent owner can show moving the boundary will result in substantial loss due to the existence of improvements. [**Roman** v. **Ries** (1968) 259 CA2d 65]

### Marking the line

When a writing setting the boundary is not available, subsequent owners must look to the prior owner's activities for an **implication** that an agreement existed as to the location of the boundary line.

For example, the construction of a fence may imply an agreement to set a boundary. However, in order for the fence to control in an agreed-boundary dispute, the owner relying on the fence as a boundary must present evidence to show the fence was erected to resolve a **boundary uncertainty known** to previous owners.

For example, a fence is erected between two parcels of real estate by the owners of the parcels. Both parcels are later sold.

The new owner of one of the parcels commissions a survey based on the legal description of the property in recorded documents. The survey reveals the 20-year old fence dividing the owner's property and the neighboring property is actually located on his property.

The owner builds a new fence on the actual boundary line located by the survey.

The neighbor then seeks to remove the new fence and obtain possession to the real estate up to the old fence line. The neighbor claims the agreed-boundary doctrine sets the boundary at the original fence line since the fence existed for 20 years without dispute.

The owner claims the agreed-boundary doctrine does not apply since the previous landowners did not agree to erect the fence based on any uncertainty as to the location of the true boundary. Can an agreement be implied to set the boundary line at the old fence?

No! The mere acquiescence to the placement of a fence, absent evidence of uncertainty and an agreement to resolve the uncertainty, is not enough to establish a boundary under the agreed-boundary doctrine. The agreed-boundary doctrine does not apply since the previous owners did not erect the fence to resolve uncertainty as to the location of the boundary. [**Mehdizadeh** v. **Mincer** (1996) 46 CA4th 1296]

Fences are built for a variety of reasons, one of which is to establish a boundary. Other reasons for erecting fences include controlling animals, aesthetics or to prevent children from wandering off a property.

Further, the location and condition of a fence may be influenced by the topography of the property, the terrain on which it is placed, requirements of an animal enclosure, or the loss of lateral and subjacent support. [Bryant, *supra*]

While a fence or wall is evidence of a line for something, a fence does not necessarily set the property boundary.

## Limitations of the doctrine

The agreed-boundary doctrine has limitations. The doctrine cannot be used to convey property. Further, the agreed-boundary doctrine can only set a boundary, the exact location of which is unknown to the adjacent owners without a survey or litigation.

Any attempt to convey a portion of a lot to the owner of an adjacent property by use of the agreed-boundary doctrine violates the Statute of Frauds which requires a writing stating the intent to convey land.

Thus, the agreed-boundary doctrine cannot be used to make *lot line adjustments*. In a **lot line adjustment**, the adjacent owners are moving an already existing line, the location of which is known to them.

Lot line adjustments require planning commission approval. [Calif. Government Code §66469 et seq.]

# Chapter 14 Common boundary structures

*This chapter is a digest of the rights and obligations of owners in common boundary disputes.*

## Shared rights and responsibilities

Most properties have three property lines which set the **common boundary** with adjacent properties owned by other people. A fourth property line usually sets the frontage on a public right of way, such as a street.

The location of the common property lines might be represented by an improvement which acts as a demarcation of the property line, called a *common boundary improvement*.

### A common boundary improvement may be a:

- party wall;
- boundary fence;
- tree line;
- driveway; or
- ditch.

Prospective buyers interested in a property should be concerned about the ownership of any common boundary improvements and who is responsible for their maintenance.

The rights of the adjacent property owners when setting up, maintaining or removing common boundary improvements depend on the type of improvement which exists.

## Party walls are owned by both

Common boundary improvements, other than trees, located on a property line between adjacent properties are called *party walls*.

A **party wall** may be in the form of a wall, fence or building which is co-owned by the adjacent property owners.

The use and ownership of a party wall should be set forth in a written agreement between adjacent property owners. The agreement defines each owner's responsibility for **sharing the cost** of maintaining the party wall. However, these written agreements rarely exist.

A prudent prospective purchaser should ask about and review any party wall agreement to determine what rights or obligations have been established regarding the party wall. However, an agreement does not need to exist, and a boundary improvement does not need to be located on the boundary for an improvement to be a party wall.

Consider an owner's building and a neighbor's building, both of which are supported by a common party wall as a part of their structure. The party wall is located entirely on the owner's property. No agreement exists regarding the use and ownership of the party wall.

The neighbor begins construction of a second story which requires raising the height of the party wall. The construction does not weaken the support of the party wall.

The owner claims the neighbor cannot raise the height of the party wall since the party wall is located on the owner's property.

However, even though the party wall is located entirely on the owner's property, it is owned by both the owner and the neighbor since it supports both of their buildings. Thus, the neighbor can construct a second story and heighten the party wall since the construction does not weaken or interfere with the use of the existing party wall. [**Tate** v. **Fratt** (1896) 112 C 613]

Similarly, an adjoining property owner cannot **remove or destroy** a party wall without the consent of the other owner since each has an interest in the party wall.

An owner can alter a party wall, such as installing cosmetic ornamentation on his side of the wall, as long as he does not injure the wall or interfere with the adjoining property owner's use of the party wall. [**McCarthy** v. **Mutual Relief Ass'n of Petaluma** (1889) 81 C 584; Tate, *supra*]

### Boundary fences and cost contributions

For security and privacy purposes, many properties are fenced in by a *boundary fence*. A **boundary fence** may be a party wall co-owned by the adjacent property owners.

Adjacent property owners have a mutual obligation to maintain the fences between them, except for an owner who allows his land to lie otherwise unfenced. [Calif. Civil Code §841(1)]

If an owner who leaves his land unfenced later decides to enclose it by using the existing fence as part of the enclosure, he must compensate the neighbor who built the fence for the pro rata value of the neighbor's fence used by the owner. [CC §841(2)]

An owner entitled to a contribution for the construction of a fence can enforce his rights through a lawsuit. [**Reusche** v. **Milhorn** (1933) 218 C 696]

### Line trees, a trunk with common owners

Trees are solely owned, government owned or commonly owned. A tree's **ownership** is determined by the location of its trunk.

Solely owned trees belong to the owner of the property on which the trunk is growing. [CC §833]

Trees growing on government-owned parcels, such as a right of way for streets and sidewalks, belong to the local government.

However, shrubbery or trees whose trunks stand partly on the land of two adjacent property owners belong to the adjacent owners as **tenants in common**. These trees are called *line trees* or *common boundary trees*. [CC §834]

Adjacent owners who own line trees as tenants in common are jointly responsible for maintaining the trees. [CC §841]

### Sharing boundary trees

**Co-owners** of boundary trees, as adjoining property owners, both enjoy the use of the trees.

For example, **use** of a boundary tree by adjacent property owners includes trimming and maintaining the trees. The co-owner who trims the tree must carry away and dispose of the tree trimmings. The co-owner must also take care not to damage the tree or interfere with the other co-owner's use of the tree.

The use allowed a co-owner of boundary trees is the same as the use allowed the owner of solely-owned trees, as long as the use does not interfere with the other co-owner's use and enjoyment of the trees.

However, consider two adjacent property owners whose parcels are separated by a row of eucalyptus trees planted on the boundary line.

One parcel of real estate contains a citrus tree grove. The adjoining parcel of real estate contains a walnut tree grove.

The walnut grove parcel lies downwind from the adjoining parcel containing citrus trees. The boundary row of eucalyptus trees shelters the walnut trees by breaking up the prevailing wind.

The eucalyptus tree branches overhang several feet into the citrus grove. The **branches** from the boundary trees are reducing the production of fruit from the citrus trees by blocking out the morning sunlight, producing a cooling effect.

The **roots** from the eucalyptus trees extend several yards into the citrus grove soil, choking out the roots of the citrus trees and depleting the soil of its nutrients within close proximity of the eucalyptus trees.

The citrus grove owner, as co-owner of the row of eucalyptus trees, wants to trim the offending branches and roots back to the property line and lower the height of the trees.

However, the walnut grove owner does not want the citrus grove owner to cut back or modify any part of the eucalyptus trees in any way that inhibits their use to him as a shelter from the wind.

Can the walnut grove owner stop the citrus grove owner from cutting down or trimming the trees?

Yes! Although both adjoining property owners have a tenants-in-common ownership interest in the boundary trees, one property owner may not alter the boundary trees to the extent that he destroys the boundary trees' **function as a shelter** to the other property. [**Anderson** v. **Weiland** (1936) 12 CA2d 730]

Additionally, an adjacent property owner cannot remove line trees without the consent of the co-owner. A co-owner is liable to the other co-owner for any losses suffered by the removal of line trees since **unilateral removal** is not a legitimate enjoyment of a tenancy-in-common ownership interest in the trees. [**Scarborough** v. **Woodill** (1907) 7 CA 39]

## Remedies

To avoid disputes, adjacent property owners can enter into an agreement detailing how they will handle the maintenance and upkeep of boundary trees.

If a boundary tree injures the *health and safety* of a property owner or prevents him from enjoying his property, the tree may constitute a **nuisance** and can be removed. [CC §3479]

A co-owner of a boundary tree might refuse to consent to the removal of a boundary tree. If the tree constitutes a nuisance, an abatement of the nuisance is allowed.

For example, boundary trees may be a nuisance if their branches or the trees themselves continually fall, threatening the safety of people using the adjacent property or damaging improvements on the adjacent property. [**Parsons** v. **Luhr** (1928) 205 C 193]

Thus, one of the property owners may have to remove or modify the offending trees at the common co-owners' expense.

# Chapter 15 Encroachments—crossing the line

*This chapter presents the rights of neighboring property owners when improvements on one owner's property encroach on the adjacent owner's property.*

### Boundaries violated, hardships balanced

After the purchase of an unimproved parcel of real estate, an owner discovers his neighbor's garage extends two feet over the boundary line onto his property, called an *encroachment*.

The owner demands the neighbor remove the **encroachment**. When the neighbor refuses, the owner seeks to compel the neighbor's removal of the two foot portion of the garage which encroaches on his property.

The neighbor claims the owner is not entitled to a removal of the improvement since:

- the encroachment was unknown to the neighbor and unintentional;
- the square footage of the owner's property affected by the encroachment is minor; and
- the cost to remove the encroaching garage would far exceed the monetary loss to the owner if the encroachment were allowed to continue.

Can the owner obtain a court order, called an *injunction*, which forces the neighbor to remove the encroaching garage?

No! The encroachment is unintentional and minor in its effect on the burdened owner. Thus, the burden to the owner does not justify an order requiring the neighbor to undertake an expensive reconstruction activity to remove the encroachment.

Instead, the owner is awarded **money damages** representing the rental value for the lost use of his property. The neighbor is granted an **easement** over the owner's property for the life of the encroaching garage, called *balancing hardships* or *balancing the equity*. [**Christensen** v. **Tucker** (1952) 114 CA2d 554]

For the neighbor to be allowed to maintain the encroachment, he has to act in *good faith* when constructing the improvements, i.e., without knowledge the improvements encroach on the owner's property. If the neighbor had not constructed the improvements in **good faith**, the owner would be entitled to an injunction forcing the removal of the encroaching structure, no matter how minor the encroachment.

For an owner to recover money losses due to an encroachment, he must act within the three-year period of the *statute of limitations*. If the owner delays too long in making his claim, the encroaching neighbor has earned the right to maintain the encroachment without compensation to the owner. The **statue of limitations** period does not run from the owner's discovery of the encroachment or his acquisition of the property, it runs from the date the encroachment was created.

Additionally, if the seller knew the encroachment existed but failed to disclose this fact, the buyer could recover his money losses from the seller. The loss would be based on the diminished value of the property and the excess purchase price paid.

## Encroachment, trespass and nuisance

An **encroachment** is an improvement on real estate, such as a building, fence, driveway or tree, which extends onto real estate belonging to another person without his consent.

Encroachment is closely related to *trespass*, *nuisance* and *boundary disputes*. All involve a nonconsensual interference with another's property rights.

Any encroachment qualifies as a **nuisance**. A nuisance can be classified as either *permanent* or *continuing*. Broadly defined, a nuisance is any obstruction of another's use and enjoyment of his real estate. [See Chapter 19]

An encroachment also qualifies as a *trespass* since the encroaching improvement actually rests on land which is the neighbor's property. [See Chapter 18]

However, the actual title given to an interference is unimportant. An owner may recover for an **unauthorized interference** with his property rights on one theory or another.

### An encroachment on whose rights?

It is not only a fee owner of real estate who can take action to stop an encroachment. Any person holding rights in real estate may protect those rights against outside interference. **Rights affected** by an encroachment include:

- *leasehold* interests [**Brown Derby Hollywood Corporation** v. **Hatton** (1964) 61 C2d 855];
- *deed restrictions*, such as limitations on the height of improvements [**Seligman** v. **Tucker** (1970) 6 CA3d 691];
- *setback* requirements [**Morgan** v. **Veach** (1943) 59 CA2d 682];
- *easements* [**City of Dunsmuir** v. **Silva** (1957) 154 CA2d 825]; and
- *prescriptive easements*. [**Warsaw** v. **Chicago Metallic Ceilings, Inc.** (1984) 35 C3d 564]

For example, consider an owner who uses a strip of his neighbor's property for access — ingress and egress — to a commercial building located on the owner's property. After the owner uses the strip for more than five years, the neighbor constructs a warehouse on the strip of land, restricting the owner's access to his building.

Here, the owner's use of the strip of his neighbor's land matured into an **easement by prescription** due to the passage of five years time. Thus, the owner is able to obtain an injunction against the warehouse improvements since they encroach on his easement rights. [Warsaw, *supra*]

### Drawing the line not to be crossed

The existence of an encroachment is easily determined by a survey to establish the location of the property line. An encroachment is present if an improvement on one parcel extends over the line onto an adjacent parcel.

Occasionally, neighboring owners disputing the existence of an encroachment rely on contradictory surveys to establish the property line. If the owners cannot agree on the location of the property line, the boundary dispute must be resolved before any encroachment remedy — if one exists — can be granted.

The resolution of the boundary dispute frequently amounts to no more than a court determining which of the competing surveys is more accurate. [**Iacovitti** v. **Fardin** (1954) 127 CA2d 348]

Once an **encroachment** has been determined, the remedies available to the owner include:

- an *injunction* ordering the removal of the encroaching structure; or
- *money damages* for the diminished value of the property subject to the encroachment.

## Balancing the hardships

The conditions for **balancing the hardships** — allowing an encroachment to continue versus its removal — include:

- the owner of the property burdened by the encroachment must not suffer an **irreparable injury** due to the continued existence of the encroachment;
- the neighbor who owns the encroaching structure must have acted in **good faith** when building the encroachment; and
- the **cost** to the neighbor of removing the encroachment must greatly exceed the damage done to the owner. [Christensen, *supra*]

For example, a neighbor's residence is located close to the property line. The eaves of the neighbor's house and a bay window extend over the property line. The encroaching portions of the house can be removed without great expense or loss of value.

The owner seeks an injunction ordering the removal of the encroaching structures. The neighbor claims removal is not appropriate since the encroachment is minimal.

Since the encroachment is minimal and the cost of removing it is equally small, the encroaching portion of the residence must be removed. [**Harland** v. **Noto** (1951) 105 CA2d 740]

Additionally, an encroachment need not be removed if its removal would adversely affect a large segment of the public.

For example, a reservoir constructed by a water company encroaches on an owner's property. The owner seeks to remove the encroachment. However, the encroaching reservoir may remain since it supplies water to many homes. [**Ukhtomski** v. **Tioga Mut. Water Co.** (1936) 12 CA2d 726]

## Good faith and innocence in an overstep

The *good faith* of a neighbor who constructs improvements which encroach on the land of another must exist before any balancing of the hardships can take place. The **good faith** requirement prevents an *intentional exploitation* of the balancing hardships rule.

For example, an unimproved parcel of real estate is subject to setback requirements. The owner of the parcel begins building a residence on the property. Soon after construction commences, the owner's neighbor notices the residence is being constructed too close to the property line and is within the setback. The neighbor informs the owner he is violating the setback requirements. The neighbor also threatens legal action unless the owner complies with the setback requirements.

Despite the neighbor's warnings, the owner completes the construction knowing the improvements violate the setback requirements. The neighbor seeks to enforce the setback requirements by forcing the removal of the structure from within the setback. The cost to the owner of moving the residence far exceeds the damage to the neighbor.

However, the owner built the residence with full knowledge of both the setback violation and the neighbor's objection. Thus, the owner did not complete the construction in good faith and the portion of the

structure within the setback must be removed. Had the owner innocently violated the setback requirements, the removal request would probably be denied. [Morgan, *supra*]

### The encroachment easement

When the continuance of an encroachment on an owner's property is allowed, the encroaching neighbor is granted an *equitable easement* to maintain the improvement on the owner's property. The easement lasts for the lifetime of the encroachment.

For example, an encroaching neighbor sought fee title to a portion of the property covered by his encroachment. However, to grant title to the neighbor would be excessive. Instead, an **equitable easement** is granted since an easement is sufficient to protect the neighbor's right to maintain the encroaching improvements and avoid *lot line adjustment* laws. [Christensen, *supra*]

### Limitations and delay

Under most circumstances, an owner seeking to terminate an encroachment or recover his money losses is subject to a **three-year statute of limitations** running from the commencement of the encroachment. [**Bertram** v. **Orlando** (1951) 102 CA2d 506]

The limitations period for an encroachment is the same as for a *permanent nuisance* since the damage to the owner is complete and certain as soon as the encroachment is created.

The **creation date** of the encroachment is critical. Whether an owner has *knowledge* an encroachment exists does not affect the statute of limitations. The limitations period runs from the creation of the encroachment, not its discovery. [**Castelletto** v. **Bendon** (1961) 193 CA2d 64]

However, in the rare case where the losses resulting from an encroachment are progressive over time, the three-year statute of limitations does not begin to run from the date the encroachment was created.

For example, an owner's building is damaged when a neighbor's building leans on it, due to a poorly compacted fill. The degree of the tilt, and the resulting damage, increases over time.

More than three years after the damage commences, the owner seeks to recover his monetary losses from the neighbor. The neighbor claims the owner is barred from recovering damages by the running of the three-year limitations period.

However, the intrusion onto the owner's building is continuous and progressive. As with a **continuing nuisance**, a new claim accrues each time the loss increases. Thus, while the three-year statute of limitations does apply, it does not begin to run on the commencement of the encroachment, but runs from the date of the last increase in money losses caused by the *progressively increasing* interference of the encroachment. [**Kafka** v. **Bozio** (1923) 191 C 746]

In addition to barring relief by the running of the statute of limitations before filing a claim, an action seeking money damages or an injunction against an encroachment can be barred by the equitable doctrine of *laches*, also called *prejudicial delay* or *detrimental reliance*.

For example, an owner discovers his neighbor is constructing a potential encroachment. However, he refrains from voicing his concerns to the owner or taking any action to resolve the potential encroachment until the construction is completed. Here, his inaction bars him from enforcing the removal of the encroachment. The encroaching neighbor has, in part, relied on the owner's acquiescence in undertaking and completing the construction. [**Rankin** v. **De Bare** (1928) 205 C 639]

Finally, an owner who allows a known encroachment on his property to continue for over five years risks losing property rights through a prescriptive easement since the adverse use of the owner's property by the encroaching neighbor is known to the owner and continuous.

Thus, an owner must promptly enforce his right to remove an encroachment or receive compensation for lost value when a neighbor's improvements first encroach on his property.

# Chapter 16 Tree encroachment

*This chapter discusses the encroachment of solely-owned trees and encroachment resolutions.*

### The root of the problem

A property owner's tree has grown so large its **branches and roots** extend into the ground and air space of his neighbor's property. The neighbor's concrete driveway and patio are damaged by the force of the expanding roots.

The roots also interfere with the natural growth of the neighbor's lawn, and fruit trees near the property line have diminished in their annual production.

Leaves and debris from the tree continually litter the neighbor's house and yard, requiring the rain gutter to be cleared regularly. The large branches of the tree hang so far over the neighbor's house they break shingles loose during windstorms and cause cosmetic damage.

The neighbor wants to hire a tree trimming service to cut the branches and roots of the property owner's tree back to the property line.

However, the owner of the tree claims his neighbor has no right to cut any part of his tree since its trunk is located on his property, not on the neighbor's property.

Can the neighbor cut overhanging tree branches and invading roots which enter his property without the permission from the property owner who owns the tree?

Yes! The neighbor may resort to *self-help* by cutting the encroaching branches and roots off the neighbor's tree. [**Bonde** v. **Bishop** (1952) 112 CA2d 1]

However, the neighbor may not cut beyond the property line. [**Fick** v. **Nilson** (1950) 98 CA2d 683]

Additionally, the extent of the removal of branches and roots is controlled by a reasonable need to remove them.

### Who owns the tree?

Trees are *improvements* and thus are considered a part of the real estate. **Ownership** of a tree is determined by the location of the trunk, not the position of the branches or roots. [Calif. Civil Code §§833, 834]

Trees whose trunks grow on a boundary line separating two adjoining parcels of real estate are called *common boundary trees* or *line trees*. **Common boundary trees** are jointly owned by the adjoining property owners. [CC §834; see Chapter 14]

Trees whose trunks are planted on one side of a boundary line belong solely to the owner of the property on which the trunks grow. [CC §833]

A solely-owned tree *encroaches* on a neighboring property when its branches or roots reach past the boundary line, sometimes called the *contiguous line* or *common property line* with the adjacent property.

A property owner confronted with **encroaching branches and roots** from a neighbor's tree has three potential remedies:

- recover his *money losses* from the neighbor;
- *use self-help* to eliminate the encroachment; and
- obtain a *mandatory injunction* ordering the neighbor to remove the encroachment.

The remedy available depends on the extent of the encroachment.

An **encroachment** can be either:

- a *permanent encroachment*; or
- a *continuous encroachment*. [**Tracy** v. **Ferrera** (1956) 144 CA2d 827]

An example of a **permanent encroachment** is the construction of a building which lies partly on a neighbor's property. Also, **physical damage** caused to the neighbor's property by an encroaching tree is considered a permanent encroachment, not a trespass. The neighbor may recover **money losses** from the adjoining property owner for the cost of repairing the physical damage to his property caused by the encroaching tree. [Bonde, *supra*]

For example, if a tree's branches fall on a neighbor's parked car and damage it, the neighbor may recover the money losses from the owner of the tree for the cost of repair or lost value.

A neighbor seeking a court award to recover his money losses caused by a permanent encroachment must file an action within three years of the time he discovers the damage caused by the permanent encroachment, if he has not yet settled the dispute with the owner of the tree. [Calif. Code of Civil Procedure §338]

## Self-help tree trimming service

If an encroachment can be *abated* (discontinued), it is considered a *continuous encroachment*. For example, a tree that does not cause physical damage, but only encroaches on a neighbor's property by its overhanging branches or invading roots, is a **continuous encroachment**.

A neighbor subjected to a continuous tree encroachment may resort to **self-help** by cutting the offending branches and roots back to the property line. [**Grandona** v. **Lovdal** (1886) 70 C 161]

A neighbor who cuts off overhanging branches from an encroaching tree may keep or discard any firewood or fruit from the overhanging branches. [**Grandona** v. **Lovdal** (1889) 78 C 611]

A neighbor may also recover reasonable costs for the self-help from the owner of the encroaching tree. [**City of Berkeley** v. **Gordon** (1968) 264 CA2d 461]

However, a neighbor cannot cut the encroaching branches or roots beyond the boundary line, kill the tree or enter the adjoining owner's property without his permission. [Fick, *supra*]

A neighbor's self-help efforts must occur on his own property. A neighbor who exercises self-help beyond his property boundary without permission is trespassing. If this happens, the **trespassing neighbor** is liable to the tree's owner for any damage caused to the tree. Further, any trespassing neighbor judged

to have acted maliciously will be responsible for a penalty amount equal to triple the damages. [Fick, *supra*]

A neighbor may only exercise self-help if a reasonable **need to remove** the encroachment exists.

For example, an owner's tree roots encroach upon a neighbor's property. The neighbor removes the roots up to the property line. As a result, the tree becomes unstable and unsafe and its owner has to remove it.

The owner of the tree seeks money damages, claiming the neighbor unnecessarily removed roots which caused serious injury to his tree. The neighbor claims he has an absolute right to remove the encroachments up to the property line.

However, the neighbor does not have an absolute right to remove encroachments up to the property line unless a **reasonable need** exists to remove the encroaching roots. Further, the roots must be removed without unreasonable injury to the tree. [**Booska** v. **Patel** (1994) 24 CA4th 1786]

### A continuous nuisance

Another type of continuous encroachment is a *nuisance*. A **nuisance** is any condition which prevents a neighbor's free use or enjoyment of his property or is injurious to his health. [CC §3479; see Chapter 16]

For example, a property owner's land is improved with a row of eucalyptus trees planted several feet inside the boundary line.

His neighbor's property contains a grove of pecan trees. The eucalyptus tree roots extend beyond the property line and into the soil of the neighbor's property, depleting the soil's nutrients.

Can the owner of the eucalyptus trees be ordered to remove or modify his trees by a mandatory injunction?

Yes! The owner of the encroaching eucalyptus trees may be ordered to abate the condition either by *modifying or removing* the trees if they are deemed to be a nuisance. [**Crance** v. **Hems** (1936) 17 CA2d 450]

The mandatory injunction remedy to remove the encroaching branches or roots is only available when the encroachment constitutes a nuisance. [Bonde, *supra*]

If a tree is not judged to be a nuisance, the owner will not be required to eliminate the encroaching roots and branches. The neighbor will then be limited to his own self-help methods. [Grandona (1886), *supra*]

Additionally, a tree owner will not be required to take corrective action to prevent interferences with a merely speculative future use of a neighbor's property.

For example, a neighbor cannot require a landowner to remove his trees simply because the trees might stunt the growth of crops the neighbor may eventually grow near the property line in the future. [Grandona (1886), *supra*]

**Air and sunlight obstructions** are insufficient interferences to warrant the elimination of trees as nuisances.

For example, a property owner has several eucalyptus trees which he has allowed to grow so large they shade his neighbor's south-facing windows from the winter sun. The neighbor had his house specifically constructed with extra south-facing windows to expose as much of the interior of the house to winter sunlight, using solar energy for heat.

The neighbor contends the trees are a nuisance since they prevent him from using and enjoying his property. The neighbor seeks a court order requiring the owner to trim or remove the trees.

Can the owner maintain the trees even though they are an obstruction of the neighbor's sunlight?

Yes! Property owners will not be ordered to give their neighbor air or light easements. Shading a home from passive solar heat, such as heat received through extra windows, is not considered a nuisance. [**Sher** v. **Leiderman** (1986) 181 CA3d 867]

However, an owner who installs *active solar collectors* is provided a **light easement** under the Solar Shade Control Act. A property owner may not plant or maintain trees or shrubs which will shade a neighbor's preexisting **active solar collector** between 10 a.m. and 2 p.m. (standard time). [Calif. Public Resources Code §25982]

## Active solar collectors

A **solar collector** which receives protection under the Solar Shade Control Act must be a *fixed device*, or part of a fixed device used to gather solar energy.

Thus, south-facing windows installed for the purpose of bringing in more sunlight do not qualify as active solar collectors. [Pub Res C §25981]

The Solar Shade Control Act does not apply to timberland trees or agricultural land.

Additionally, if a tree or shrub has been growing before a neighbor installs an active solar collector, the owner of the property containing the tree or shrub may replace it if it dies subsequent to the installation of the solar collector. [Pub Res C §25984]

## Broker responsibility

A listing broker for a single family residence must diligently inspect a property and disclose adverse information on the property's condition which might affect a prudent buyer's decision to acquire the property. [**Easton** v. **Strassburger** (1984) 152 CA3d 90]

The listing broker's **visual inspection** of the property should include his observation of the surface roots and branches of trees located both on the listed property and on the neighboring properties which may encroach on the listed property in the future. If the listing broker observes an encroachment or believes one is likely to occur, the information must be given to the prospective buyer.

The listing broker should further inform the buyer of the steps he or the seller can take against **encroaching trees** should the buyer decide to purchase the property.

# Chapter 17 Government-owned trees

*This chapter covers the legal nature of trees as real estate and focuses on government-owned trees.*

### Maintenance and liability

A tree stands in a public right of way, its trunk located in the frontage area between a property owner's parcel of real estate and the curb of the street. A property owner believes he owns everything in front of his house up to the street curb and has unlimited free use and enjoyment of all the land between his home and the street curb.

The owner considers the tree unsightly and removes it. The city's Parks and Recreation Commission discovers the tree has been removed and fines the property owner for unlawfully removing the city's tree.

Can the city control the planting, removal and maintenance of trees located in the area between the street curb and the property line?

Yes! The land from the owner's front property line to the middle of the street belongs to the city. The front property line divides the owner's parcel of real estate from the city owned right of way. In this sense, the owner and the city are adjoining property owners.

The city's right of way includes:

- the street or highway (usually surfaced with asphalt);
- the curb and gutter;
- the sidewalk (usually made of concrete) which may be adjacent to the property line or along the street curb;
- street light poles; and
- street side plots of soil or grassy areas with trees.

Although a property owner typically maintains grass in the area between the curb and his property line, he may not remove the trees located in the right-of-way area without city permission. Thus, a property owner must treat the trees as property of another, even though the trees grow in front of his parcel of real estate. [See Chapter 10]

**City-owned trees** pose two main problems for a property owner:

- maintenance, modification or removal of the tree; and
- damage from the tree to the owner's property or to users of the owner's property.

## Maintenance of city-owned trees

A city may adopt a *tree policy* authorized by the state legislature. However, a city is not required to implement and use the statutory tree policy. If the city adopts the state's tree policy, the city cannot apply provisions from any other policy. [Calif. Streets and Highways Code §22002]

However, if the city charter and the statutory tree policy are in conflict, a city's charter will control.

Under state guidelines, a city may set up a board of one or more persons and call it the Tree Department, the City Parks and Recreation Commission or any similar name it desires. This board will oversee the maintenance, planting, removal and care of trees, parks, shrubs and vegetation within the city. [Str & H C §22008]

The board can create and enforce ordinances that comply with state guidelines for trees growing on city-owned property. [Str & H C §22031]

The city may impose a penalty for the illegal removal of its trees. If a property owner wants a city-owned tree removed, he must comply with the city's ordinances controlling those trees. For example, a city can allow an owner to obtain a permit to remove offending trees by himself, or it can permit the removal of city trees only by persons authorized by the board.

It is essential for a property owner to be sure he is complying with city ordinances before he removes or modifies trees growing in the city's right of way. The owner will need to ascertain which department of the city has authority to oversee and enforce the tree policy.

For example, a city board supervising the tree policy may be a division within the city's Parks and Recreation Commission.

The board can order the removal of any tree or tree part likely to fall which is posing a danger or obstructing public travel, whether the tree is on city or private property. [Str & H C §22060]

If a tree is growing on private property, the board must provide the property owner with written notice ten days before removing the tree, unless the tree is an immediate threat to public safety. [Str & H C §22061]

The property owner has seven days to file an objection to the tree's removal with the board. If the owner files an objection, the board may not cut down the tree until it provides the owner with an opportunity to be heard, or until an agreement is reached regarding the tree's removal. [Str & H C §22062]

When the board decides to plant, maintain or remove trees growing along city streets, it may tax the parcels of land affected by the improvements. The board is also authorized to use money from the city's general fund appropriated for the tree policy, which it generally does. [Str & H C §22034]

## Government liability for its trees

The ability of a person injured on public property to recover money losses from the government agency owning the property depends on the condition of the property at the time of the injury.

For the purpose of determining a government agency's liability for injuries to others on its property, the property is classified as either:

- unimproved property in its natural state; or
- improved property altered by the agency's ownership of the property.

If a tree growing on city property is left in its natural and unimproved state and as a result injures a person using the property, the city is not liable for the injury. A person using unimproved public property takes on the risk of injury while enjoying the benefits of using the property in its natural condition. [Calif. Government Code §831.2]

Unimproved property does not necessarily have to be in its original, pristine condition. Evidence of maintenance and preservation of public property will not render the property improved for the purpose of determining whether or not a city or government agency is liable for injuries occurring on the property.

However, owners of real estate adjacent to **unimproved public property** who are injured by trees growing on the public property are able to recover their losses from the city or government agency. Government immunity only applies when the injured person is a user of the city property.

Consider a property owner who lives next to an unimproved city park. Several large eucalyptus trees in the city park grow near the adjoining property owner's house.

One of the eucalyptus trees falls on the owner's house, destroying the roof and causing the property owner emotional distress. The owner makes a demand on the city to recover his money losses.

The city claims it is immune from liability since the park is unimproved public property.

Can the owner recover his losses from the city?

Yes! *Government immunity* from injuries suffered on unimproved public property applies only to users of the property, not property owners whose real estate lies adjacent to or near the city property. [**Milligan** v. **City of Laguna Beach** (1983) 34 C3d 829]

## Injury on unimproved government land

Liability does exist for injuries to users of **improved public property**. Improved public property is property altered by humans with artificial conditions or improvements in selected areas of the property.

For example, a park with a restroom and picnic facilities would be considered improved public property. However, a user of a city park with improvements installed only in some areas of the park may not recover money losses from the city for injuries he suffered while using an unimproved portion of the park. [**Fuller** v. **State** (1975) 51 CA3d 926]

A city is not liable for injuries to users of either improved or unimproved city property if the city voluntarily undertakes activity to protect users of the property but fails to warn the public about dangerous conditions the city knows or should have known about.

For example, a city beach is unimproved. The city provides lifeguards for an area designated for swimming. A swimmer drowns when he is caught up in a riptide. The swimmer's family claims the city is liable for the swimmer's wrongful death since it provided lifeguard services, implying a duty of care owed to users of city property. The city claims it is immune from liability for the swimmer's drowning because the beach is unimproved public property in its natural condition.

Is the city liable for the swimmer's death?

No! Public beaches have been designated as unimproved and exist in their **natural condition**. The city's placement of lifeguards on the beach does not alter its natural condition and does not eliminate the city's immunity. Citizens cannot hold cities liable for failing to warn swimmers of a natural condition such as a riptide. [Gov C §831.21]

Additionally, when a city employs staff to supervise and maintain its property, it is not necessarily undertaking a duty of care for users of the property.

Consider a group of teenagers who enter a city's unimproved park to drive their all-terrain vehicles (ATVs).

The city has not altered the property, but it employs park rangers who help **maintain and supervise** the property and **enforce** the city's park policies.

One of the teenagers becomes paralyzed as a result of an accident that occurs while he is driving his ATV in the park. The injured teenager claims the park ranger should have warned him about any dangerous conditions existing in the park. The teenager also claims the city is liable for his injuries since it voluntarily provided the area for park users since the city employed rangers to supervise the park.

Is the city liable for the teenager's injuries?

No! The park rangers were hired to care for the property, not people. Thus, the city has not assumed responsibility for persons injured while using the **unimproved property**. [**Mercer** v. **State** (1987) 197 CA3d 158]

# Chapter 18 — Trespass: a violation of possession

*This chapter examines the activities which constitute trespasses on real estate and lists the available remedies.*

## Ejectment, liabilities and title risks

A *trespass* is any wrongful and unauthorized entry onto real estate in the possession of another.

Thus, a **trespass** is an interference with another's **possession** of real estate, which is distinct from any interference with **title** or an **ownership interest**. [**Brenner** v. **Haley** (1960) 185 CA2d 183]

The person entitled to stop a trespass is not necessarily the fee simple owner or the owner's agent. Anyone in possession of the property, such as the fee owner, a life estate owner, a tenant or even a person in wrongful possession, has the right to stop a trespass. [**Allen** v. **McMillion** (1978) 82 CA3d 211]

A fee owner can even trespass on the property he owns in fee simple when the property is in the legal possession of another person, such as a tenant.

For example, a landlord who enters a leased premises without a tenant's permission (except after giving proper notice, or in an emergency) is liable for a trespass, called *forcible detainer*. A landlord has no possessory rights in the property during the term of a rental or lease agreement, only a **reversionary interest**.

*Privileged entries* protect landlords and others against liability for **trespass**, such as entering property possessed by another in case of an emergency, to abate a nuisance or to serve legal papers.

For example, a property owner is authorized by statute to enter a neighbor's property to abate a nuisance if that nuisance affects him, such as a fire hazard. Any owner who enters his neighbor's property to *abate a nuisance* must first give notice and on entry conduct himself in a peaceable manner. [Calif. Civil Code §§3502, 3503]

### Trespasser liability for harm done

When an entry is not privileged, it is considered a trespass. A trespasser incurs **civil liability** for the monetary amount of any losses or injury he causes to the occupant's person, real estate or personal property.

An occupant of property, who might be someone other than the fee owner, can recover his money losses for injuries resulting from a trespass. Conversely, damage to the fee owner's property caused by the person who is in rightful possession, such as a tenant, is not a trespass, it constitutes *waste* since he has impaired the property's value. [**Smith** v. **Cap Concrete** (1982) 133 CA3d 769]

*Editor's note — Although the test for who can stop a trespass or recover money losses is possession, not ownership, the term "owner" will be used for convenience throughout this chapter. Bear in mind that the owner seeking to stop a trespass could also be a tenant, licensee, transient guest or other occupant.*

An owner may bring an action for trespass against a trespasser even when the trespasser caused no actual injury by his presence in the owner's property. If no injury has occurred, the owner may only recover *nominal money damages* from the trespasser. **Nominal money damages** are awarded when a wrong has

been committed under the law but has not resulted in a money loss. [**Staples** v. **Hoefke** (1987) 189 CA3d 1397]

To recover *actual money damages* for a trespass, an owner must sustain an actual loss. **Actual money damages** recoverable for a trespass are based on:

- injury to the real estate;
- lost use of the property;
- personal injury; and
- injury to the occupant's personal property.

### Indirect trespass

A trespass does not require the trespasser's direct physical presence on the property. A trespass can result from an **indirect entry** into another's property, sometimes called *trespass on the case*.

For example, one can be liable on a trespass for damages caused by activities such as:

- depositing dirt or debris on another's property [**Armitage** v. **Decker** (1990) 218 CA3d 887];
- leaving toxic waste on another's property [**Mangini** v. **Aerojet-General Corporation** (1991) 230 CA3d 1125];
- leaving personal property on real estate belonging to another [**Herond** v. **Bonsall** (1943) 60 CA2d 152];
- diverting a river or surface waters across another's property [**Salstrom** v. **Orleans Bar Gold Mining Co.** (1908) 153 C 551];
- starting a fire and negligently allowing the fire to move onto a neighbor's property [**Elton** v. **Anheuser-Busch Beverage Group, Inc.** (1996) 50 CA4th 1301]; or
- allowing one's animals to wander across another's property. [**Montezuma Improvement Co.** v. **Simmerly** (1919) 181 C 722]

### Money losses of value and rents

An owner who is completely deprived of the use of his property by a trespasser is entitled to recover the **rental value** for the use of the property during the period of the trespass. [CC §3334(b)]

For example, a tenant who leases property for the purpose of running a restaurant leaves restaurant equipment on the premises after the lease expires. Due to the presence of the equipment, the owner is unable to use the property. Thus, the owner can recover the rental value of the premises from the former tenant for as long as the equipment remains on the premises. [Herond, *supra*]

The amount of money damages recoverable for injuries to the real estate caused by a trespasser can be based on either **lost property value** or the **cost of restoring** the property to its condition prior to the trespass. Under most circumstances, an owner of real estate damaged by a trespass will be awarded the lesser of the two amounts or a dollar amount most appropriate to cover his loss. [Armitage, *supra*]

The most straightforward recovery situation arises when a trespasser inflicts an injury to a property which diminishes its value, since the owner simply recovers the amount of the lost property value. For example, an owner may recover the lost value of his property from a neighboring property owner who diverts water across his property, washing away soil and crops. [Salstrom, *supra*]

However, many trespasses involve more than a simple loss in property value. An owner is not required to accept any changes to his property caused by a trespasser without his consent, and may recover **costs of restoration** regardless of any change in the value of the property.

For example, a neighbor builds a road across an owner's property without the owner's consent, destroying a number of trees in the process. The construction of the road actually increases the value of the owner's property, but the owner prefers the trees for their aesthetic value. Thus, the owner is able to recover the reasonable cost of restoring the property to its condition before the trespass i.e., replacing the trees. [**Heninger** v. **Dunn** (1980) 101 CA3d 858]

*Reasonable* means the restoration costs must be balanced against the lost value **actually suffered** by the owner. In Heninger, the owner did not recover the cost of restoring the property to its **exact** condition before the trespass, since the cost to replace trees of the same growth would have been several hundred thousand dollars more than the value of the real estate itself. The reasonable cost of restoration was limited to planting new trees which would grow over time.

Additionally, for an owner to recover money from a trespasser for the restoration of a property to its pre-trespass condition, out-of-pocket money losses must have actually been spent by the owner on the restoration. [Heninger, *supra*]

Aside from the money losses sustained by the owner, a trespasser has liability exposure for **punitive damages** if the trespass and resulting property damage is intentional and malicious. [CC §3294]

For example, if a property owner's neighbor trespasses and is intentionally malicious, such as trampling flower beds or removing plants from the property, the neighbor is liable for punitive damages, a judicial money award constituting a penalty. [**Griffin** v. **Northridge** (1944) 67 CA2d 69]

### Injunction to abate a trespass

Besides recovering money losses, an owner can obtain a court ordered **injunction** to stop a person who is a continuing trespasser.

A single isolated trespass is not a basis for an injunction. However, if seeking money damages would not prevent a trespass from being repeated in the future, the rightful occupant can obtain an injunction against the trespasser. [**Standard Lumber Co.** v. **Madarys Planing Mill** (1921) 54 CA 107]

### Trespass on livestock land

An owner of real estate attempts a controlled burn of brush on his property.

Due to the owner's negligence, the fire spreads onto a neighboring property which is used for raising livestock. The fire damages plant life on the neighboring property which served as fodder for his livestock. The owner is found liable for money losses sustained by the neighbor due to the fire.

The neighbor claims he is entitled to attorney fees since the fire was a trespass. The owner claims attorney fees are not recoverable since the fire was not a trespass.

In this example, the fire, which was started by the owner and moved onto the neighbor's property, constitutes a trespass. Thus, the neighbor whose property is used to raise livestock and was damaged by the escaping fire is entitled to attorney fees. [Elton, *supra*]

When a trespass occurs on real estate which is under cultivation or is intended or used to raise livestock, the owner of the real estate is entitled to attorney fees for the action in addition to the damages caused by the trespass. [Calif. Code of Civil Procedure §1021.9]

### Physical damage by invasive conduct

Consider a property owner's residence which is adjacent to a public utility easement. Powerlines which emit electromagnetic fields (EMFs) are located on the easement.

The owner claims the utility company is liable for trespass since the EMFs are a **physical invasion** of the owner's property which renders it uninhabitable and has diminished the property's value.

Is the utility company liable for trespassing on the owner's property due to the EMFs?

No! The utility company is not liable for trespass since the EMFs are an **intangible intrusion**, a condition which does not physically damage the property or its occupants. [**San Diego Gas and Electric Company** v. **Superior Court** (1996) 13 C4th 893]

### Criminal trespass on refusal to leave

In addition to the liability for property damages, a trespasser may also incur **criminal** liability. Trespassing becomes a **misdemeanor** when the trespasser:

- *refuses to leave the property* on foot or in a vehicle when requested by the owner, the owner's agent, a person in lawful possession of the property or a law enforcement officer acting on request from the person entitled to possession [Calif. Penal Code §602(k), (n)];
- enters and *occupies the property* without the rightful owner's consent [Pen C §602(m)];
- *refuses to leave a transient occupancy* establishment (hotel/motel/vacation property) on the request of the owner or manager [Pen C §602(s)];
- *enters a private dwelling* [Pen C §602.5]; or
- *enters industrial property* (such as an oil field, a gas or electric plant or a railroad yard) where posted signs forbid trespassing. [Pen C §554]

A crime is not committed by merely entering another's property, except when the property is a private residence or posted industrial property.

For example, a group of individuals who camped for one night on an owner's property without his permission are arrested for trespassing at the request of the owner. The owner claims the campers have committed a misdemeanor since they occupied the property without his consent.

However, the mere *transient use* of a property for a campsite does not constitute occupation of the property, resulting in a criminal trespass. Criminal occupancy requires an ongoing *continuing possession*. Thus, the campers committed no crime. [**People** v. **Wilkinson** (1967) 248 CA2d Supp. 906]

### Removing trespassers by ejectment

An owner's first course of action when confronted with a trespasser is to simply request the trespasser to leave. If the trespasser does not **leave when requested**, he commits a *misdemeanor*. [Pen C §602(l)]

An owner himself may not **forcibly eject** a trespasser. To discourage disturbances of the peace caused by self-help, California law allows both tenants and trespassers to recover damages from the landlord or

property owner for **forcible entry and detainer** — a forcible interference with an individual's peaceful possession of a property, even if that individual's possession is wrongful. [CCP §§1159, 1161, 1172]

An owner may only recover possession of his property from a trespasser through a court action, except when the trespasser is a transient occupant who failed to depart as agreed. The type of action brought to recover property depends on the type of possession held in the property.

For example, the action to recover possession of a property from a tenant in default on his lease obligations is an *unlawful detainer* (UD) action. In the case of a trespasser occupying property, the legal remedy is an *ejectment* action.

**Ejectment** is similar to a UD action but has less stringent proof of trespass requirements. The trespasser in an ejectment action, unlike the tenant in a UD action, never has to have legal possession of the property for an owner to have the trespasser legally removed.

In an action to eject a trespasser, an owner (or other occupant) must prove he has a superior right to possession of the property. The owner may then obtain a court order for the removal of the trespassers from his property, called a *writ of possession*. The court order is carried out by the sheriff, not the owner. [CCP §715.010]

In the case of trespass on **public lands**, the state stands in the role of the owner or occupant of the property for the purposes of ejecting trespassers and recovering money losses. [Calif. Public Resources Code §§6224.1, 6302, 7992]

### Transient occupants removed by police

Guests who have checked into a hotel, motel, vacation rental or similar establishment are called *transient occupants*. The owner or operator of the establishment is called an *innkeeper*.

A **transient occupant** who refuses to leave the premises when requested to do so by the **innkeeper** is guilty of a *misdemeanor* for lodging without permission. A transient occupant is also committing a misdemeanor if he obtains accommodations and then refuses to pay or leave the premises at check-out time. [Pen C §602(s), 647]

In both cases, the innkeeper may call the police for assistance in removing the person who has become a trespasser.

Once the police officer arrives, if the transient occupant continues to **refuse to leave** the property, the occupant by refusing to leave is committing a crime in the presence of the officer. The officer then has the authority to arrest the occupant as a trespasser and remove him from the premises. [Pen C §836(a)(1)]

### Owner's risk of liability or lost rights

Even if an owner is not troubled by trespassers who use his property, he must consider his risk of:

- liability for *injuries to trespassers* entering into his property; and
- *losing* some or all of his *property rights* through prescription or adverse possession.

Every property owner must take reasonable precautions to prevent injuries to others on his property, since he is liable for injuries to others, even trespassers, caused by unsafe conditions on the property. [CC §1714]

The ownership liability applies whether the injured person is a trespasser or an invited guest on the owner's property. [**Rowland** v. **Christian** (1968) 69 C2d 108]

An exception to ownership liability applies to property owners who permit others to use their property for **recreational purposes**. A property owner is not liable for injuries to persons using his property for recreational purposes, unless he:

- invites the users onto his property, rather than merely permits the use;
- charges consideration for entry; or
- intentionally or maliciously fails to warn or protect against a known hazardous condition. [CC §846]

Owners frequently seek to use the **recreational activity immunity** as a defense against liability for injuries occurring on their property. For example, a child is injured while riding a bicycle on a *construction site*. The owner of the property claims he is exempt from liability for the injury since the child was using the property for recreational purposes.

However, to enjoy immunity from liability for injuries to recreational users, an owner must prove his property is suitable for recreational use. Since a construction site is not suitable for recreational purposes, the owner is not immune from liability. [**Paige** v. **North Oaks Partners** (1982) 134 CA3d 860]

### The prescription in an on-going trespass

*Prescription* is a process for acquiring property rights to use another's property, such as an easement, through adverse use hostile to the rights of the owner. [See Chapter 20]

An adverse user of real estate, hostile to the owner's rights, is a **trespasser**. If allowed to continue long enough without interruption, a trespass matures into a property right through prescription. An owner must take steps to avoid the risk of a trespasser establishing permanent prescriptive rights to his property.

One easy solution for an owner is to grant a trespasser a **revocable right** to use his property. When an owner gives **permission** for someone to use his property, the use is not adverse, and thus a prescriptive right to use cannot be established.

Additionally, an owner can post signs on his property stating the right to pass is by permission, subject to revocation and the control of the owner. No prescriptive easement can be established based on the period of time after the revocable permission signs are posted. [CC §1008]

Finally, to best protect his property rights, an owner should record a notice stating permission to use his property is revocable. [CC §813]

### Adverse possession and owner inattention

A trespasser who occupies property without the consent of the owner can be ejected by a court order at any time, and can also be charged with a misdemeanor. [Pen C 602]

However, a trespasser can **acquire title** to the entire property by **adverse possession** if he can manage to maintain exclusive possession of the property as a trespasser for a period of five years. To establish title by adverse possession, the trespasser's possession must be open and known to the owner, and the trespasser must pay all property taxes. [**Gilardi** v. **Hallam** (1981) 30 C3d 317]

Adverse possession differs from prescription in that it is a claim for **title** to the real estate. Conversely, prescription merely involves a **right to use** another's property.

Similar to prescription, one safeguard against adverse possession is to grant the occupant permission to use the property.

However, merely granting permission will not prevent adverse possession in all cases. For example, possession of a property might be based on **color of title**, meaning the occupant has a deed which is defective for some reason (such as forgery) and a good faith belief he owns the property (he paid the purchase price and received title insurance). Granting permission will not affect a claim for adverse possession based on color of title. [See Chapter 27]

The most prudent remedy against a trespasser seeking to establish adverse possession is an action for ejectment. Conversely, when the trespasser occupies under color of title, a quiet title action is required to clear title of the cloud created by the color of title.

# Chapter 19 Nuisance: offensive, unhealthful, or obstructive

*This chapter defines a nuisance, distinguishes it from trespass and describes a property owner's remedies to stop it.*

## Interference with use and enjoyment

A nonresidential tenant stores hazardous materials on leased property as permitted in his lease agreement. The agreement requires the tenant to return the property to the landlord in its **original condition** on the expiration of the lease.

The hazardous materials maintained on the leased property by the tenant contaminate the soil. When the lease expires, the tenant vacates the premises without cleaning up the contamination.

Several years after the tenant leaves, the landlord discovers the contamination and incurs cleanup costs, called *damages*. The landlord then seeks to recover **damages** from the tenant, claiming he created a *nuisance* by leaving the property contaminated with hazardous materials.

The tenant claims he is not liable for a **nuisance** since:

- a nuisance is an activity created or carried out on one property and affecting another property, not an activity occurring solely on the property affected;
- he no longer has a possessory interest in the property; and
- the landlord consented to his use of the property to store hazardous materials.

Is the tenant liable for losses incurred by the landlord caused by the nuisance he created?

Yes! The tenant does not escape liability to the landlord for the cleanup costs since:

- a nuisance is any harmful or obnoxious activity which obstructs an owner's use of his property, regardless of where the nuisance arises;
- the person who creates a nuisance does not need to have a possessory interest in the property to be liable; and
- the landlord did not consent to the tenant leaving contamination on the property after the lease expired. [**Mangini** v. **Aerojet-General Corporation** (1991) 230 CA3d 1125]

## What is a nuisance?

A *nuisance* is anything which:

- is **offensive** to the senses;
- is **injurious** to health; or
- **obstructs** the use of property. [Calif. Civil Code §3479]

Thus, a nuisance is any activity which interferes with the **use and enjoyment** of property, including conditions which are unhealthy or offensive to the senses.

The common law definition of a nuisance was limited to conduct on one property which interferes with the use and enjoyment of a different property. However, a nuisance is now broadly interpreted to encompass a wide variety of activities.

Consider a residential landlord who maintains his rental units in an **unsafe condition**. In addition to being a breach of the implied warranty of habitability, the tenants may also pursue an action against the landlord for maintaining a nuisance. A **residential landlord** maintains a *nuisance* by failing to care for and maintain his units, and he is liable to the tenants for their losses, including relocation expenses. [**Stoiber** v. **Honeychuck** (1980) 101 CA3d 903]

A nuisance does not need to be offensive to the senses or injurious to health to constitute a nuisance. A **nuisance** only needs to interfere with the *use and enjoyment* of a property right in some **physical manner**.

Consider an owner of a business operating on premises located next to an airport. Above-ground fuel storage tanks are located on the airport property approximately 500 feet from the business premises.

The business owner claims the tanks are a nuisance since he fears he will die if the tanks rupture or explode due to an accident, and that fear interferes with his use and enjoyment of his property.

However, the proximity of the fuel storage tanks is not a nuisance. An occupant's fear of future invasion does not constitute a physical interference with his use and enjoyment of his land. [**Koll-Irvine Center Property Owners Association** v. **County of Orange** (1994) 24 CA4th 1036]

Similarly, electro-magnetic fields (EMFs) emitted by power lines located on an easement next to an owner's property are not a nuisance. No study has found conclusive scientific proof that EMFs are a health hazard. [**San Diego Gas and Electric Company** v. **Superior Court** (1996) 13 C4th 893]

Neighboring property owners inevitably create some degree of **annoyance or inconvenience** for each other, but not every annoyance rises to the level of a nuisance.

An activity becomes a nuisance based on either:

- a statutory provision identifying conduct that is a *nuisance per se*; or
- a balancing of the conflicting rights and interests of the neighboring property owners.

## Nuisance per se by statute

A *nuisance per se* is any activity specifically declared by statute to be a nuisance. If an activity is a statutory nuisance, it can be enjoined without proof of its harmful or offensive effect.

The list of **nuisances per se** is wide and diverse, including:

- fences of excessive height unnecessarily exceeding ten feet, called *spite fences* [CC §841.4];
- the illegal sale of controlled substances [CC §3479];
- fire hazards [Calif. Public Resources Code §4171]; and
- swimming pools which do not comply with statutory health and safety standards. [Calif. Health and Safety Code §116060]

Conversely, some activities are declared by statute not to be nuisances.

Activities done or maintained under the express authority of a statute, called *statutory authority*, cannot be nuisances. For example, the activities of a commercial agricultural processing plant are maintained under **statutory authority** and cannot constitute a nuisance. [CC §§3482, 3482.6]

However, the side effects of statutorily authorized activities are not exempt from nuisance liability. For instance, a city waste treatment plant near an owner's residence produces offensive and unhealthy odors. The adjacent property owner seeks to abate the nuisance.

The city claims the owner cannot have the nuisance abated since it has the statutory authority to operate a waste treatment plant.

However, the statutory authorization for the operation of a waste treatment plant does not also authorize the city to produce a noxious and unhealthy stench. Thus, the odors constitute an abatable nonexempt nuisance, even while the treatment plant creating them is exempt. [**Varjabedian** v. **City of Madera** (1977) 20 C3d 285]

Similarly, an activity authorized by a **zoning ordinance** limits the possible remedies for nuisance. Any activity carried out under a zoning ordinance does not constitute a nuisance and cannot be stopped by an injunction. [Calif. Code of Civil Procedure §731a]

However, *zoning immunity* does not extend to activities which are conducted in an unnecessarily or excessively offensive manner.

Consider, a property owner who operates a music studio in a building as permitted by zoning. However, the structure housing the music studio does not contain soundproofing. Also, loud music is played on the property late into the night with the windows and doors open.

The studio owner's neighbors complain of the noise and seek an injunction against the owner's operation of the music studio. The owner claims the neighbors are barred from obtaining an injunction since his property is zoned for use as a music studio.

However, the owner of the music studio is not entitled to disturb his neighbors by creating excessive noise beyond the permitted use. Thus, the owner is enjoined from operating the music studio at noise levels and during hours which unreasonably disturb the neighbors. [**Gelfand** v. **O'Haver** (1948) 33 C2d 218]

### Balancing rights: inconvenient or improper

When an activity is not a nuisance per se, to determine whether a **nuisance** exists, a *balancing of the rights* of the neighboring property owners is applied.

Every owner is entitled to use his property for any lawful purpose. However, an owner is limited in his conduct since his permitted use may not unreasonably interfere with the right of others to use and enjoy their property. [CC §3514]

An owner's use of his property often creates some degree of inconvenience for the occupants of neighboring properties. However, to constitute a nuisance, the inconvenience created by an owner's use of his property must be serious enough to be an **improper interference** with another's use and enjoyment of his property.

Whether an activity is a nuisance is determined on a case-by-case basis. An activity which is a nuisance in one set of circumstances may not be a nuisance in another, depending on such factors as:

- the frequency and time of day of the activity;
- the number of inhabitants in the area; and

- the injury or inconvenience caused to occupants of surrounding property by the activity. [**McIntosh** v. **Brimmer** (1924) 68 CA 770]

For instance, the typical day-to-day use of a family-occupied residence inevitably creates noise which is audible to the neighbors. However, production of family noise, within reasonable limits, is not a nuisance.

Consider a homeowner who constructs a basketball court in his backyard for recreational use. The court is only used during the afternoon and never for more than one hour on any day.

The owner's neighbor complains of the noise from the basketball games and claims the owner is maintaining a nuisance. The neighbor seeks an injunction to prevent the owner from playing basketball on his court.

In this instance, the owner's use of the basketball court is well within reasonable limits. Basketball noise, so long as it is not excessive, is not a nuisance. Thus, an injunction to abate reasonable amounts of game noise can not be obtained by the neighbor. [**Schild** v. **Rubin** (1991) 232 CA3d 755]

In a similar case the with opposite outcome, basketball playing was enjoined as a nuisance since very noisy and rancorous games were repeatedly carried on late at night. [**Alexander** v. **McKnight** (1992) 7 CA4th 973]

### Public vs. private nuisance

A **nuisance** may be a public nuisance, a private nuisance or both.

A *public nuisance* is a nuisance which affects an entire neighborhood or segment of the public. [CC §3480; Calif. Penal Code §370]

Stopping a **public nuisance** is the responsibility of state or local government authorities. Officials may seek to abate or enjoin the nuisance, recover money damages or bring criminal misdemeanor charges against the offender responsible for the nuisance. [Pen C §372]

A private property owner may not stop a public nuisance unless the public nuisance especially obstructs the owner's use of his property, making the interference a private nuisance as well. [CC §3493]

For a private owner to abate a public nuisance by an injunction, he must sustain injuries to himself or to his property which are **different in kind** from the interference or injuries sustained by the public at large.

A difference in the **degree of interference** alone does not make a public nuisance a private nuisance. [**Venuto** v. **Owens-Corning Fiberglas Corporation** (1971) 22 CA3d 116]

Continuing with our previous example, consider the owner of property located 500 feet from aboveground fuel storage tanks at an adjacent airport. The property owner claims the fuel tanks are a private nuisance since the tanks diminish his property's value, raise insurance premiums and reduce the usefulness of his business premises.

However, the owner is unable to abate the public nuisance himself since he did not suffer an **injury different in kind** from any other member of the public. [Koll-Irvine Center Property Owners Association, *supra*]

Now consider an owner of real estate which is contaminated by hazardous waste dumped by a previous owner. The current owner conducts tests and discovers the hazardous waste has contaminated not only his property, but neighboring properties as well.

In this instance, the owner can recover cleanup costs from the previous owner for maintaining both a public and private nuisance. The owner's cost of testing his property is an injury which the **public did not also suffer** by the nuisance. [Mangini, *supra*]

## Remedies of suppression or money

The remedies for a public or private nuisance are:

- abatement, by suppression or termination of the interference [CC §3495]; and
- a civil action for an injunction and money losses. [CC §§3501, 3493]

An owner has the right to take self-help actions to reduce or put an end to a private nuisance affecting his property if he can do so without creating a disturbance of the peace or causing injury. [CC §3502]

For instance, **self-help abatement** of a private nuisance typically occurs when an owner cuts off the limbs of a neighbor's tree which encroach onto his property. [See Chapter 16]

A **civil action** to end a nuisance involves seeking an **injunction** (to stop the activity or condition creating the nuisance), *money losses* from those responsible for the nuisance, or both.

The **money losses** an owner seeks to recover for a neighbor's nuisance are based on either:

- actual money losses for injury or loss of value to his real estate, or for injury to himself; or
- intangibles, such as emotional distress and personal discomfort.

For example, a homeowner affected by noxious odors emanating from a neighboring sewage treatment plant may recover **money damages** based on:

- diminution in the property's value caused by the odors; and
- personal discomfort resulting from the odors, including nausea and burning eyes. [Varjabedian, *supra*]

Additionally, an owner may recover **punitive damages** for the willful or malicious creation of a nuisance.

Consider a homeowner's neighbor who uses his property for the excavation of sand and gravel.

The owner fears his neighbor's excavation will damage his property due to the lack of lateral support and complains to the neighbor. Also, the city informs the neighbor the excavation violates zoning laws. The neighbor continues the excavation despite the protests.

After a portion of the owner's property subsides due to the neighbor's excavation, the owner sues the neighbor for maintaining a nuisance.

In addition to his money losses for the diminished value of his property, the owner recovers punitive damages. The neighbor continued excavating after the owner and the city complained, and had full knowledge of the potential damage he might inflict on the owner's property. [**McIvor** v. **Mercer-Fraser Co.** (1946) 76 CA2d 247]

## Nuisance vs. trespass

Nuisance and trespass are closely related. The two categories overlap since both involve injury to, or interference with, the property rights of another. The distinction is based on whether a physical entry onto another's property occurs.

Trespass requires a **physical entry** on another's property which can be direct or indirect — i.e., the trespasser can either personally enter the property or deposit materials indirectly, such as dirt and debris from construction activity.

In contrast, a nuisance is an **outside interference** with an owner's or tenant's use and enjoyment of his property resulting from a condition or activity which physically remains outside the property.

Thus, trespass is based on an **interference with the possession** since it affects the real estate. A nuisance is an **interference with the enjoyment** of property since it affects the senses of the applicants.

For instance, **noise is a nuisance** to occupants of another property if the noise is loud, annoying and continuous. Noise is not a trespass since no physical invasion of property occurs, except for sound waves which *affect the senses*, not the property. The noise creates no interference with the possessory rights in another's property and thus is not a trespass. [**Wilson** v. **Interlake Steel Company** (1982) 32 C3d 229]

However, the distinction between nuisance and trespass does not mean the categories are mutually exclusive. Nuisance is broadly defined by statute as anything which is injurious to health or obstructs the use of property, regardless of whether the condition exists on or off the affected property. Thus, an invasion of property which qualifies as a trespass is also a nuisance if the trespass rises to an unhealthful or offensive condition.

For example, consider a tenant who leaves behind hazardous materials which contaminate the leased property after the lease expires. The **contamination** is both:

- a *trespass*, since it interferes with the landlord's possession of his property; and
- a *nuisance*, since it is harmful to the public's health. [Mangini, *supra*]

Once a nuisance is **fully abated**, the property subjected to the nuisance is freed from any *loss in value*. Thus, the basis for calculating the recovery of money for the pre-existing nuisance no longer exists since the nuisance no longer exists.

Consider an owner of real estate who discovers a contamination from a neighboring property has intruded into his property. The contamination is a nuisance which is fully abatable since it can be cleaned and completely removed from the property.

The owner claims he is entitled to recover the future loss of the property's market value from the neighbor since a stigma will remain with the property after the contamination is removed.

However, the owner is unable to recover any loss of market value since the *nuisance* which impaired his property will **no longer exist** once the contamination is fully removed. [**Santa Fe Partnership** v. **Arco Products Company** (1996) 46 CA4th 967]

## Remedies held by local government

Any public body or officer authorized by law may take steps to abate a public nuisance. [CC §3494]

When an agency succeeds in any action or proceeding against an owner of real estate to abate a nuisance, the owner responsible for the nuisance is liable to the agency for their costs of abatement, including administrative costs, abatement expenses and court costs. [Calif. Government Code §25845(b)]

Additionally, the owner will be liable for the agency's attorney fees if a local ordinance allows for recovery of attorney fees in an action to abate a nuisance. [Gov C §25845(c)]

A local governmental agency may choose one of two methods to collect abatement expenses from an owner of real estate:

- record a *nuisance abatement lien* against the property for the amount of the abatement expenses [Gov C §38773.1]; or
- add the abatement expenses to the property's tax bill as a *special nuisance abatement tax assessment*. [Gov C §38773.5(a)]

A **nuisance abatement lien** may be foreclosed by a governmental agency as a judgment lien. [Gov C §38773.1(c)(3)]

Should a **nuisance abatement tax assessment** remain unpaid for three years, the assessed property can be sold by the tax collector. [Gov C §38773.5]

## Permanent or continuing nuisance

The type of money losses an owner can recover for property damage caused by a nuisance depends on whether the nuisance is *permanent* or continuing. A **permanent nuisance** exists when the nuisance cannot be abated at a reasonable cost and by reasonable means. [**Mangini** v. **Aerojet-General Corporation** (1996) 12 C4th 1087]

Conversely, a **continuing nuisance** exists if the nuisance can be reduced or terminated at any time and at a reasonable expense.

The money losses inflicted by a permanent nuisance are determined at the time the permanent nuisance is created. Losses inflicted by a continuing nuisance are limited to the actual injuries suffered prior to termination of the nuisance. [**Spar** v. **Pacific Bell** (1991) 235 CA3d 1480]

## Permanent nuisance remedies

A **permanent nuisance** cannot be abated at a reasonable expense or by reasonable means. Thus, an owner's only remedy is a recovery of *money losses* calculated as the diminished value of his property caused by the nuisance.

For instance, a building on a neighbor's property encroaches on the adjacent owner's property. The **encroachment** is a permanent nuisance since it perpetually obstructs the use and enjoyment of the owner's property and cannot be removed at a reasonable cost to the neighbor.

In balancing the rights of the adjacent owner and the encroaching neighbor, the cost to the neighbor to abate the nuisance by removing the encroaching improvements far exceeds the loss of the owner's use. Thus, the owner is entitled to monetary compensation for the lost use of the portion of his property hindered by the encroachment, but he cannot abate the encroachment itself. [**Christensen** v. **Tucker** (1952) 114 CA2d 554]

Additionally, a **permanent nuisance** may be permitted as an *easement*.

For example, an airport acquires a prescriptive easement on the airspace over a neighboring owner's property since aircraft entering and exiting the airport have used the same flight path over the property for more than five years.

The noise from aircraft flying over the owner's property is a permanent nuisance, but the owner is barred from recovering any money losses since the airport now holds an easement permitting the (noisy) use of the airspace. [**Institoris** v. **City of Los Angeles** (1989) 210 CA3d 10]

## Continuing nuisance remedies

In the case of a **permanent nuisance**, an owner can recover *money losses* equal to the permanent decline in his property's value caused by the nuisance.

However, recovery for a **continuing nuisance** cannot include lost property value since the nuisance can be entirely eliminated. The condition causing the diminished value will no longer exist once the nuisance is removed. Thus, no permanent loss in value occurs to be recovered. [Alexander, *supra*]

The primary remedy for a **continuing nuisance** is an *abatement* to remove the nuisance or an *injunction* ordering the nuisance to be stopped. However, an owner can also recover the costs he incurs to remedy the damage done by the nuisance to his real estate.

Consider a property owner who discovers contaminated soil on his real estate which presents a continuing hazard. Thus, the contamination of the soil is not permanent but will continue until it is cleaned up.

The prior owner of the property operated a business on the property which caused the soil contamination.

The owner claims the prior owner is liable for cleanup costs since he maintained a continuing nuisance on the property. The prior owner claims he cannot be liable for a continuing nuisance since he had the right to contaminate the property while he owned it.

In this instance, the prior owner is liable for the current owner's **cleanup costs** since the contamination creates a **continuing unhealthy condition** on the property. [**KFC Western, Inc.** v. **Meghrig** (1994) 23 CA4th 1167]

In addition to an injunction, other money losses which can be recovered by the owner are limited to:

- the lost use of the property until the nuisance is abated, such as rental value;
- the cost of cleanup or repairs necessary to eliminate the nuisance; and
- any expenses incurred due to personal injury or emotional distress caused by the nuisance.

**Statute of limitations on recovery**

The status of a nuisance as *permanent* or *continuing* affects recovery under the three-year statute of limitations barring further claims based on the nuisance. [CCP §338]

For instance, an action on a **permanent nuisance** must be brought within **three years** after the nuisance becomes permanent. However, in the case of a **continuing nuisance**, a new cause of action accrues and the three-year statute of limitations begins to run anew each day the nuisance continues, or when further damage is inflicted on the property.

Consider a tenant who discharges gasoline onto the leased real estate, contaminating the soil. Later, a buyer acquires the property. The buyer discovers the soil contamination and cleans it up.

Less than three years after the clean up is complete, the buyer seeks to recover the cleanup costs from the tenant who created the nuisance.

The tenant claims the buyer's recovery is barred by the three-year *statute of limitations*. The buyer claims recovery is not time barred since the contamination is capable of being removed, making it a *continuing nuisance*.

The buyer's action for nuisance is not barred by the three-year statute of limitations since the contamination is a continuing nuisance and the limitations statute does not begin to run until the contamination is completely removed. [**Wilshire Westwood Associates** v. **Atlantic Richfield Company** (1993) 20 CA4th 732]

An owner can take steps to abate a continuing nuisance at any time during the existence of the nuisance, regardless of when the nuisance was first created.

However, an owner cannot recover money for losses spent to eliminate a continuing nuisance which he incurred more than three years before filing the action.

# Chapter 20 Easements running or personal

*This chapter presents the various types of easements and the rights and obligations unique to each.*

## Rights in another's property

An *easement* is the right of one property owner **to use** the property of another. A typical **easement** is used for *ingress and egress*, which is a right of way allowing one property owner to traverse a portion of another's land (the easement) to access his property.

Consider a right-of-way easement which is maintained as a road over an owner's property. The easement provides **access** thorough the owner's property from a public street to an adjoining neighbor's property.

The owner builds a fence on his property line, blocking the neighbor's use of the road and access to the public street.

The neighbor, as the owner of property benefitting from the easement, claims the easement gives him the right to use the roadway, a use the owner cannot interfere with by fencing the perimeter of his property to exclude the neighbor.

The neighbor demands the unobstructed use of the road and seeks to recover money losses incurred due to the owner's obstruction.

Is the owner wrongfully blocking his neighbor's use of the road?

Yes! The neighbor holds a valuable **property right** in the owner's property which entitles him to use the right-of-way easement, classified as an *appurtenance* to the neighbor's property.

When an owner whose property is burdened by an easement interferes with the use of the easement by a neighbor whose property benefits from the easement, the neighbor is entitled to have the use of the easement reinstated, either by removal, relocation or modification of the interference.

Further, the neighbor who holds the easement is entitled to compensation for his money losses caused by the owner's obstruction of the neighbor's use of the easement. [**Moylan** v. **Dykes** (1986) 181 CA3d 561]

## Benefits and burdens of ownership

An easement creates a relationship between two parcels of real estate since it:

- **benefits** one property, referred to as the *dominant tenement*, whose owner is entitled to use the easement; and
- **burdens** another property, referred to as the *servient tenement*, the owner's use of which is subject to the easement.

## Appurtenant or in gross: does it run?

An easement burdening an owner's property as an *encumbrance on his title* is classified as either:

- an **appurtenant easement**, since the allowed use belongs to and benefits an adjacent property and *runs with the land* as an interest held in the burdened real estate; or
- an **easement in gross**, which belongs to an individual, not land, as his *personal right* in the burdened real estate.

For example, a development company sells parcels in a subdivision, reserving a right-of-way easement over each of the parcels. The deed creating the easement does not state the easement is *appurtenant* to other parcels.

Later, the successor to the developer attempts to build a road on the easement. The owners of the burdened property claim the easement is **in gross**, a benefit held only by the original developer.

Is the easement in gross (personal) since the grant deed does not specify the easement is appurtenant?

No! When the document creating an easement does not indicate whether the easement is appurtenant or in gross, the easement is classified as *appurtenant* if it **benefits a property** other than the burdened property. [**Elliot** v. **McCombs** (1941) 17 C2d 23]

### Runs with title to the benefitting property

An *appurtenant easement* is incidental to the title of the property which benefits from its use. An easement is not reflected as a recorded interest on the title to the parcel of land it benefits, nor is it a personal right held by a particular individual who may now or have previously owned the land benefiting from the easement.

Accordingly, an **appurtenant easement** is recorded as an encumbrance on title to the burdened property. The easement remains on the property's title after either the benefitting or burdened property are conveyed to new owners. To be enforceable, the easement does not need to be referenced in the grant deed conveying either property to new owners since it runs with the land. [Moylan, *supra*]

Conversely, an *easement in gross* benefits a person, not the real estate owned by that person. An easement in gross is personally held only by the individual who may use the easement. No parcel of real estate can benefit from an easement in gross since only the individual holding the easement can benefit.

For example, an easement held by a public utility company is an **easement in gross**. The utility company has the right to enter onto a property to install and maintain its equipment (power lines, gas or water pipes, etc.). In no way does the real estate owned by the utility company benefit from the easement.

While an easement in gross is a **personal right** which is not transferred with the sale of any real estate owned by the holder of the easement, the right can be *transferred* by the easement holder to another person by a writing — unless the transfer of the easement in gross is prohibited by a provision in the document creating the easement. [**LeDeit** v. **Ehlert** (1962) 205 CA2d 154]

### Easements for light, air or view

A property owner has no automatic right, and can not acquire a prescriptive right, to air, light or an **unaltered view** over neighboring properties.

However, a property owner can hold an easement created by a grant which restricts a neighbor's ability to erect or maintain any improvement interfering with the owner's right to air, light or view. The easement might be the result of conditions, covenants and restrictions (CC&Rs) which blanket several properties with use restrictions on height, etc.

Consider a seller who conveys a parcel of real estate to a buyer before the invention of television. The seller retains ownership of an adjoining parcel improved with an apartment complex. The seller, by a provision in the grant deed conveying the parcel, **reserves an easement** for light, air and an unobstructed view over the property sold to the buyer.

Later, the buyer of the burdened property erects a television antenna. The seller, as the owner of the adjacent apartment complex, demands the buyer remove the antenna, claiming the antenna interferes with the unobstructed view easement he reserved.

The buyer claims the seller could not have intended to preclude the use of a television antenna since the easement was created before the invention of television.

Is the buyer obligated to remove the antenna from the space established as a view easement?

Yes! The easement precludes the buyer of the burdened property from erecting or maintaining **any type of improvement** obstructing the seller's (the apartment complex owner's) right to light, air or view. [**Petersen** v. **Friedman** (1958) 162 CA2d 245]

**Easements** for light, air and view can only be established by *written agreement* between neighboring owners, not by implication or prescription. [Petersen, *supra*]

## Solar easements and shady neighbors

A relatively recent type of easement is the *solar easement*. **Solar easements** were established with the intent of encouraging, as public policy, the productive use of solar energy systems.

A solar easement granted in a written instrument must state:

- the measured angles by which sunlight must pass;
- the hours of the day during which the easement is effective;
- the limitations on any object which would impair the passage of sunlight through the easement; and
- the terms for terminating or revising the easement. [Calif. Civil Code §801.5]

Solar easements are similar to easements of light, air or view since they restrict an owner's ability to maintain any improvements interfering with a neighbor's solar energy system.

Consider a restrictive covenant which limits the height of improvements within a housing development. A property owner's tree exceeds the height limitation and his neighbor successfully enforces the restrictive covenant requiring the owner to maintain the tree below the designated height.

In this instance, had the neighbor installed a solar collector on his property, he would have received an incidental benefit from the height restriction since it limits the height of improvements which could hinder the passage of sunlight to his solar collector. [**Ezer** v. **Fuchsloch** (1979) 99 CA3d 849]

A neighboring property owner who installs an *active solar collector* is, by his conduct, granted a solar easement across an adjacent property under the Solar Shade Control Act without the need for a writing. The adjacent property owner may not later plant and maintain trees or shrubs which will shade between 10 a.m. and 2 p.m. (standard time) an **active solar collector** previously installed by a neighboring property owner. [Calif. Public Resources Code §25982]

For easements created on an owner's property by a neighbor's conduct under the Solar Shade Control Act, trees or shrubs growing on the owner's property prior to the neighbor's installation of a solar collector may remain and are not subject to height restrictions. They were in place before the neighbor's solar collector was installed. Thus, no height limit on preexisting trees or shrubs exist, unless established by a recorded height restriction on improvements. [Pub Res C §§25980 et seq.]

Additionally, if a tree or shrub has been growing before a neighbor installs an active solar collector, the owner of the property containing the tree or shrub may replace it if it dies after the solar collector is installed. [Pub Res C §25984]

## Conservation easements

A *conservation easement* is a voluntary conveyance — by an owner of real estate to a conservation organization or government agency — of the right to keep the land in its natural, scenic, historical, agricultural, forested or open-space condition. A **conservation easement** can be created in the form of an easement, covenant, condition or restriction (CC&Rs), by use of a deed, will or other instrument to convey the easement. [CC §815.1]

Conservation easements are *perpetual* in duration and thus are binding on all successive owners of the property burdened by the conservation easement. [CC §§815.1, 815.2(b)]

Conservation easements can only be granted to organizations established to acquire and hold a conservation easement, namely:

- a tax-exempt, nonprofit organization qualified to do business in the State of California whose primary purpose is to preserve, protect or enhance land in its natural, scenic, historical, agricultural, forested or open-space condition or use;
- a state or a governmental entity authorized to acquire and hold title to real estate, as long as the conservation easement is voluntarily conveyed; and
- a federally recognized California Native American tribe or a nonfederally recognized California Native American tribe on the contact list of the Native American Heritage Commission. [CC §815.3]

Consider a conservation easement recorded by the California Costal Commission (Commission) on a parcel of real estate in an environmentally sensitive area. The owner of the parcel built a highly visible three-hole golf course on the property without notifying the Commission, violating the conservation easement.

20 years later, the owner sold the property to a buyer without disclosing the existence of the conservation easement. Also, the title insurance company did not reveal the easement to the buyer.

On discovering the existence of the golf course on the property protected by the conservation easement, the Commission ordered the buyer to return his property to its natural state. The buyer refused, claiming the Commission was prohibited, or *estopped*, from enforcing the easement since the Commission failed to act on the long-standing violation when the prior owner built the golf course, leading the buyer to believe no violation existed. The Commission claimed it was not **estopped** from enforcing the conservation easement since its inaction was based on the belief the parcel was in compliance.

Can the buyer be forced to comply with the conservation easement even though he was not aware of its existence?

Yes! The Commission's inaction was based on the belief the parcel was in compliance with the easement, not an intent to mislead the buyer. Additionally, the public interest in the conservation easement superseded the buyer's right to maintain a golf course on his property. [**Feduniak** v. **California Costal Commission** (March 27, 2007) __CA4th__]

*Editor's note — The title insurance company and the prior owner may be liable to the buyer for the loss of value caused by the undisclosed easement.*

### Public registry for conservation easements

Conservation easements held by the state will be listed in a central public registry maintained by the Secretary of the Resources Agency.

Information included with each conservation easement listed in the registry will include:

- the county recorder's document number;
- the date the easement was recorded;
- the purpose of the easement;
- the location of the easement, identified by county and nearest city;
- the identity of the easement holder; and
- the size of the easement in acres.

This registry will be available to the public on the internet by January 1, 2009 and updated biennially.

# Chapter 21 Creating an easement

*This chapter presents the methods used to create an easement.*

### By grant, reservation or implication

The basic method for creating an easement is by a writing. Any document which may be used to convey a legal interest in real estate may be used to create an easement.

An easement can be created between the benefitting and burdened properties in an easement agreement, will, grant deed, easement deed, quitclaim deed, lease, order of the court or covenants, conditions and restrictions (CC&Rs).

While the document creating an easement does not have to be recorded, an *unrecorded easement* is no longer enforceable when the owner of the burdened property sells it to a buyer who has no knowledge of the easement, called a *bona fide purchaser (BFP)*.

An **easement** is created in a *conveyance* either by:

- *grant*; or
- *reservation*.

For example, the owner of adjacent parcels of real estate can sell one parcel to a buyer and further **grant** the buyer an easement on the parcel retained by the owner.

Alternatively, an owner of adjacent parcels may sell a parcel, and in the grant deed conveying the parcel, **reserve** an easement on the parcel conveyed for the benefit of the parcel retained.

### Creative wording and certainty of purpose

Whether created by grant or reservation, uncertainties due to **omissions** and **ambiguities** in the words creating an easement are often the cause of most disputes involving easements created by a conveyance. To avoid uncertainties, the instrument creating the easement should fully state:

- the names of the grantor and grantee of the easement;
- a description of the property burdened by the easement;
- the legally described location of the easement granted or the portion reserved by exception;
- the intended use for the easement; and
- whether the easement is *appurtenant* or *in gross*.

### Easement or fee title conveyed by deed

The terms *reservation* and *exception* in conveyances of real estate are used to distinguish whether the legally described reservation or exception is, respectively:

- created for the benefit of another property, such as an *easement by reservation*; or
- retained as the property of the seller, an *exception for land* which is not transferred with the title conveyed.

The terms **reservation** and **exception** are often mistakenly used interchangeably. However, their meanings and operative effects are very different.

For example, when a grantor conveys one of two adjoining parcels he owns, **reserving** the **right to use** a road on the property conveyed, the grantor has created an *easement by reservation*.

In contrast, if the grantor conveys the property by **excepting** the road, he has not conveyed title and retains ownership to the portion of the property described as the road.

The difference between a **reservation** and an **exception** is apparent in the manner that title insurance companies write a policy on the transfer of title.

If property is conveyed *reserving* a road, the title insurance policy will insure title to the **entire parcel**, then state the title is subject to the easement created by the reservation.

Alternatively, if the property is conveyed *excepting* the road, the portion of the parcel described as the road **is not part** of the legally described property covered by the title insurance policy. The excepted portion did not become the buyer's property. Ownership of the described portion containing the road is retained by the seller as an **exception** to the parcel conveyed.

Consider a subdivider who sells a parcel of real estate to a buyer, "saving and excepting" a strip of the parcel for use as a future road.

The subdivider later claims he may build a railroad on the strip since the strip is his property, having been excepted from the legal description of the neighboring owner's parcel.

The buyer of the parcel containing the strip claims the subdivider cannot build a railroad on the strip since it is reserved as a roadway easement.

Did the subdivider except the strip and thus retain ownership to the roadway portion of the parcel sold?

No! The subdivider's deed describing the roadway strip as an exception with the further reference to the **use of the exception** for roadway purposes creates an *ambiguity*. The ambiguity establishes an uncertainty as to whether or not fee title was retained by the subdivider.

When an **ambiguity** exists as to whether the seller has reserved an easement or excepted a portion of the property from the sale, the seller is presumed to have conveyed all the property and created an easement by reservation. Thus, a roadway easement exists since title to a portion of the parcel was not retained as an exception in the conveyance. [**Coon** v. **Sonoma Magnesite Co.** (1920) 182 C 597]

## Conduct creates an implied easement

An easement can be created by conduct without any prior agreement between the owner and the user, called an *implied easement*.

**Implied easements** exist when the circumstances surrounding an owner's *division of his property* and sale of a portion of the property imply the owner (grantor) and the buyer (grantee) intended either:

- the grant of an easement on the portion retained by the owner; or
- the reservation of an easement by the owner on the portion sold. [Calif. Civil Code §1104; **Palvutzian** v. **Terkanian** (1920) 47 CA 47]

For example, an owner conveys a parcel of real estate to a buyer which is served by a network of irrigation pipes extending from a well on an adjacent parcel retained by the owner.

The grant deed conveying the parcel sold does not mention any right to use the well water. No other water source is readily available to the parcel sold.

The buyer takes possession and commences to use the water to irrigate his use of the property. Later, the owner refuses to allow the buyer to continue using the well as his source of water.

Is the buyer as the new owner of the parcel entitled to the continued use of the well?

Yes! All the requirements establishing an **implied easement** to use the well for water are present:

- a prior *common ownership* of adjoining parcels;
- a *transfer of one* of the adjoining parcels;
- an obvious and apparent *prior use* of one parcel for the benefit of the other parcel during the period of common ownership — evidenced by the well and irrigation pipes running from the adjoining parcel to the parcel sold; and
- a *reasonable necessity* for creating the easement since there is a lack of available water. [**Greene** v. **Fickert** (1942) 49 CA2d 511]

The following sections review and apply these four elements of an implied easement.

### Prior common ownership of parcels

A transfer of one of two or more adjoining parcels by a **common owner** is required to create an implied easement.

For example, an implied easement may arise when a **co-ownership** of a property is terminated and the property is divided and parcelled out to the individuals who were the co-owners.

Consider a network of irrigation ditches from a well which provides water throughout a property held by co-owners. The property is partitioned and distributed in kind to the individual co-owners without mention of the water rights.

In this instance, each co-owner's parcel is entitled to an implied easement for both the flow of water through the irrigation ditches from the parcel with the well, and the use of the well which is the source of the water since the co-ownership of the partitioned property was a common ownership. [**Anaheim Union Water Co.** v. **Ashcroft** (1908) 153 C 152]

Additionally, an implied easement may arise on the distribution of property under a will or trust.

For example, a beneficiary receives a parcel of real estate which is accessible only by a road over an adjoining parcel conveyed to another beneficiary under a will or inter vivos (living) trust which does not provide for an easement.

In this scenario, a right-of-way easement is created by implication since the common ownership of the adjoining parcels is the estate or trust. [**Cheda** v. **Bodkin** (1916) 173 C 7]

## Division by transfer

An owner of property who uses a portion of his property for the benefit of another portion of the same property does not create an easement on his own property.

An easement is a right to **use another's land**, or **prevent another** from a particular use of his land. Thus, an owner cannot hold an easement over his own land. [CC §805]

Only the division of commonly owned parcels by the transfer of a parcel triggers the creation of an implied easement.

## Beneficial use of commonly owned parcels

The prior use of one parcel for the benefit of an adjacent commonly owned parcel must be *obvious* and *permanent* for the new owner of one of the parcels to establish the right to an implied easement to use the other parcel.

To establish an implied easement, the **prior use** by the common owner must have been:

- either *known* to both the common owner (original grantor) and the buyer (grantee), or so obvious their knowledge can be presumed;
- *regularly used* during the common ownership before the transfer; and
- *intended* to be permanent.

The purpose for creating an implied easement is to establish the right to continue an existing use a buyer and seller intend to permanently maintain, but fail to mention.

Thus, an implied easement is not created when the common owner of adjacent parcels and the buyer of one parcel do not intend for an easement to exist on the adjoining parcels.

For example, a subdivider sells a parcel. The subdivider retains an adjacent parcel which has a heating plant with heat and water pipes running to the parcel sold.

At the time of the sale, the subdivider and the buyer enter into a service agreement providing for the buyer to receive the heat and water in exchange for payment of a service fee.

Later, the subdivider refuses to allow the buyer the continued use of the heat and water pipes on the subdivider's property.

The buyer seeks to establish an easement for the use of the pipes claiming an implied easement was created on the transfer of the parcel to the buyer by the subdivider.

Has an implied easement been created?

No! Although the criteria for an implied easement appears to be present, the written agreement charging a **fee for the use** of the pipes between the subdivider and buyer indicates the permanent benefits of an implied easement appurtenant to the property sold were not intended. [**Warfield** v. **Basich** (1958) 161 CA2d 493]

### Reasonable necessity to use another's

Finally, for an implied easement to exist, the easement must be *reasonably necessary* for the beneficial use of the parcel whose owner is seeking to establish the easement.

Consider a owner who sells and conveys a parcel containing a driveway. The owner uses the driveway to access an adjoining parcel he owns which is improved by his residence. The owner does not reserve an easement for use of the driveway in the conveyance to the buyer. The owner's residence fronts on a pub-

lic road. However, the driveway through the buyer's parcel is the only improved access to the owner's residence.

On closing, the buyer refuses to allow the owner to use the driveway over the parcel sold to him.

The owner claims he is entitled to an implied easement over the parcel sold to the buyer since, prior to the sale, the driveway provided access to the adjoining property he retains.

The buyer claims the owner is not entitled to an implied easement since he can build a new driveway to the public road at a reasonable cost.

Is the owner entitled to an implied easement to use the buyer's driveway?

No! An implied easement (by reservation) is not reasonably necessary to the owner's beneficial use of the adjacent property he retained since the owner can build a new driveway to the public road at a reasonable cost. [**Leonard** v. **Haydon** (1980) 110 CA3d 263]

Thus, an implied easement is created for the benefit of property only if a **reasonably convenient alternative** is not available to the property and a reasonable necessity for the easement exists.

### Implied grant vs. implied reservation

Although California codes only refer to implied grants of an easement, case law has established an *implied reservation* of an easement on property sold. [CC §1104]

For instance, a seller maintains irrigation ditches to control the flow of water on two adjoining parcels of real estate he owns and operates for agricultural purposes.

The seller conveys the parcel containing the water source to an investor and the adjoining parcel to a farmer. The deeds do not make mention of irrigation or water easements.

The investor eliminates the irrigation ditches on his property, blocking the farmer's only access to the source of his water.

The farmer claims he has an implied easement for the use of the irrigation ditches for the flow of water.

Is the farmer entitled to an implied easement over property conveyed to the investor under a deed which does not reference an irrigation or water easement?

Yes! An implied reservation is created as though the easement had been reserved by the seller in the grant deed to the investor. The seller's *pre-existing use* of the irrigation ditches on the property acquired by the investor is apparent, and the ditches were constructed to be *permanent* and are the only source of water to the parcel acquired by the farmer. [Palvutzian, *supra*]

Thus, the same criteria is used to establish an implied easement by either grant or reservation.

However, if a buyer does not have knowledge of the previous use of a parcel of real estate from the county records, or the existing use is not obvious on an inspection of the property, the buyer will be considered a *bona fide purchaser* (BFP) and will take title to the property without the easement.

### Implied easement by reference to map

When a landowner records a subdivision map and offers to dedicate the roadways depicted on the map to a public use, a *public easement* is created on the **government's acceptance** of the right of ways legally described on the subdivision map. [Calif. Government Code §§66410 et seq.]

Similarly, when a recorded subdivision map lays out acreage into parcels and streets and sells the lots by reference to the subdivision map, the buyers of the lots have easements in the streets adjoining their lots. [**Danielson** v. **Sykes** (1910) 157 C 686]

However, consider an owner of contiguous parcels who sells one of the parcels. The grant deed to the buyer describes the parcel conveyed by reference to a parcel map. The parcel map depicts a roadway crossing the parcel conveyed. No reference is made on the map to a road, easement or exception to the parcel in favor of the owner.

After closing, the owner grades a lane on the roadway across the buyer's parcel for use as a private road. The buyer refuses to allow the owner to use the roadway.

The owner claims he has reserved an implied easement for the use of the roadway since the grant deed conveying the property references the parcel map which depicts the road.

The buyer claims an easement does not exist since the reference to the parcel map in the grant deed is not sufficient notice of the owner's intent to reserve an easement over the roadway.

Does the owner have an implied easement over the roadway?

No! An implied easement in favor of the owner does not exist. Referencing the parcel map in the grant deed as part of the legal description of the property conveyed does not put the buyer on notice of the owner's undisclosed intent to reserve an easement across the parcel at the location of a roadway depicted on the map. [**Mikels** v. **Rager** (1991) 232 CA3d 334]

### Implied is appurtenant

Regardless of how an *implied easement* is created, it is always a **burden** on one parcel of land for the **benefit** of another parcel. Thus, an implied easement is always an *appurtenance* allowing the owner of the property benefitting from the easement to use the property of another which is burdened by the easement.

Most disputes over implied easements occur after the property benefitting from the easement has been deeded out to one or more new owners.

To be entitled to an implied easement, the new owner must establish the implied easement is a right of use in another property which existed when one of the parcels was deeded out to the new owner by the common owner of both parcels.

### Easements by necessity

An *easement by necessity* is a variation of an implied easement. The demand for an **easement by necessity** arises when property is **landlocked**. Access to and from a public roadway across all adjacent properties is denied in land locked property for the lack of the ability to create an easement by agreement or prior conduct.

Since public policy favors the productive use of land, an easement by necessity will be created when property is landlocked. [**Reese** v. **Borghi** (1963) 216 CA2d 324]

However, to establish an easement by necessity, the user must:

- show *strict necessity*; and
- defend against any claim that the property was **intended to be landlocked**.

**Strict necessity** requires the easement to be the only possible means of access. [**Zunino** v. **Gabriel** (1960) 182 CA2d 613]

Additionally, an easement by necessity lasts only as long as the necessity exists. Thus, if a public road is built or an existing adjacent road is dedicated to the public, an easement by necessity is terminated since the need is terminated.

No *time limitations* exist for bringing a quiet title action to establish an easement by necessity since the easement legally exists as long as the necessity exists.

Even if an easement is strictly necessary to access property (i.e., landlocked), an easement will not be created contrary to the intent of the original grantor dividing and transferring the parcel.

For example, a subdivider sells one parcel and retains another parcel which is landlocked. The deed for the parcel sold does not make mention of an easement to provide access to the landlocked parcel. Also, physical roadways do not exist.

Later, a potential buyer inquires about purchasing the landlocked parcel. The subdivider advises the buyer an easement does not exist to provide access to the landlocked parcel he is buying.

The buyer closes the purchase transaction assuming he will be able to establish an easement for access at a later time. The neighboring property owners refuse to grant the buyer an easement.

Is the buyer entitled to an easement by necessity so he can access and make use of his property?

No! An easement by necessity across the neighboring parcels does not exist since the subdivider:

- did not intend for the property to be accessible; and
- advised the buyer that an easement does not exist which provides access to the property. [**Hewitt** v. **Meaney** (1986) 181 CA3d 361]

Consider an owner whose property is landlocked and surrounded by other property with no access to the highway.

Originally, the federal government held title to all the properties involved. The federal government previously granted the State of California the property now held by the owner.

The parcels surrounding the owner's property were bought from the federal government by the owner's neighbor. A dispute arises when the owner asserts an easement by necessity exists across the surrounding property.

The neighbor who owns the surrounding property claims an easement by necessity does not exist over his property since the state never exercised the power of eminent domain to establish an access route when it owned the property.

The owner claims an easement by necessity exists since the federal government, being the prior common owner, did not intend the property to be landlocked.

However, strict necessity no longer exists once the surrounding property owned by the federal government is conveyed to the neighbor. The state owning the land-locked parcel has the power of eminent domain and no necessity for an easement exists where eminent domain exists.

Thus, when the state conveyed the property to the owner, the easement by necessity requirements could not be met since the parcels were not owned by the same owner at the time of conveyance. [**Moores** v. **Walsh** (1995) 38 CA4th 1046]

To acquire the easement, the owner's purchase should have been contingent on the state condemning an easement and then conveying the property.

## Prescription: easement by adverse use

Consider a property owner who has used a roadway on an adjoining property to access his vacation home for over five years. The owner has never received permission from the neighbor to use the roadway.

The neighbor sells his property to a buyer who informs the owner he can no longer use the roadway.

The owner claims his open and continuous use of the road to access his property for more than five years entitles him to a **right-of-way easement** over the adjoining property.

Is the owner entitled to a roadway easement over the adjoining property owned by the buyer?

Yes! A *prescriptive easement* is established by the **adverse use** of another's property for a period in excess of five years. [**Thomson** v. **Dypvik** (1985) 174 CA3d 329]

An easement created by **prescription** is similar to acquiring land by adverse possession. The difference is prescription establishes the right to **mere use** of another's property, whereas adverse possession is an actual taking of **exclusive possession** under a claim of ownership and the payment of **property taxes**.

To meet the legal requirements for acquiring an **easement by prescription**, the adverse use must be:

- *obvious* enough to give the owner of the property notice of the use;
- a *continuous* and uninterrupted pattern of use;
- a use *unauthorized* by the owner of the property;
- used under a *claim of right*; and
- used for a period of *five-or-more* years without the owner acting to terminate the adverse use.

The five-year requirement of uninterrupted use continues with the transfer of the benefitting property to new owner(s) as long as the new owner(s) continue the same unauthorized use of the burdened adjoining property established by the previous owner, called *tacking*.

**Tacking** refers to the use of another's property by successive owners of a property. The periods of use by each successive owner are tacked together to make up the continuous period of time required by the statute of limitations to establish an easement for the current owner. [**Jones** v. **Young** (1957) 147 CA2d 496]

## Prescriptive easement, not adverse possession

A prescriptive easement cannot bar an owner of property burdened by the easement from all use of his land. To obtain the **exclusive use** and possession of real estate, a claim for adverse possession must be pursued which, unlike a prescriptive easement, requires the payment of liens and taxes on the property by the adverse possessor.

For example, a neighbor builds a woodshed knowing a portion of the shed encroaches on an adjacent owner's property.

Over five years later, the owner seeks to have the neighbor remove the encroaching woodshed and return possession of the property.

The neighbor claims he is entitled to an exclusive prescriptive easement to maintain the woodshed since it has been openly occupied in a hostile manner for over five years.

Here, the neighbor is not entitled to an exclusive prescriptive easement to maintain the woodshed. An **exclusive prescriptive easement** would completely prohibit the owner from any use of his property.

Further, the owner is not entitled to a mandatory injunction requiring the neighbor to remove the woodshed. Instead, the owner is entitled to **monetary relief** from the neighbor for the lost value of the portion of his property subject to the encroachment. [**Harrison** v. **Welch** (2004) 116 CA4th 1084]

Consider an owner of real estate who erects a new fence on the property line after discovering a 20-year old fence dividing the property was not located on the legally described boundary.

The owner's neighbor requests the old fence to be reconstructed at its original location, removed from the legally described boundary line. The neighbor claims he holds a prescriptive easement across the property between the point where the old fence used to be and the new fence.

In response, the owner seeks to quiet title to the disputed portion of his property, claiming a prescriptive easement with the right to maintain the old fence is equivalent to taking his title by adverse possession since he would be excluded from any use of or access to the disputed portion of his property blocked by the old fence.

In this instance, the neighbor is not entitled to a prescriptive easement which would return the fence to its original location. A prescriptive easement is barred since an **easement coupled with a fence** would create an *exclusive right to possession* of the owner's property by the neighbor which is the equivalent of a fee interest. [**Mehdizadeh** v. **Mincer** (1996) 46 CA4th 1296]

Additionally, consider a property owner who purchases land within a common-interest-development (CID). A contiguous parcel is owned by the CID for a roadway. The property owner constructs a fence around his house. More than five years later, a survey reveals the owner's fence encroaches upon the roadway.

The owner claims he has a prescriptive easement over the roadway parcel since his use of the parcel was open and continuous for more than the statutory five-year period. However, the owner's use of the roadway constitutes adverse possession, not an easement, since the fence completely bars the CID's use of the land. [**Kapner** v. **Meadowlark Ranch Association** (2004) 116 CA4th 1182]

### Easement limited to use

Like all easements, a **prescriptive easement** is limited in its use to the *parameters of the use* which created the easement.

For example, a neighboring rancher acquires a prescriptive easement for a right of way over an owner's property — an easement benefitting the neighboring ranch.

The rancher only uses his easement for two months each year as the easiest means for accessing his ranch.

Later, the rancher subdivides his property into residential lots. The rancher claims his prescriptive easement allows him to construct a road on the easement for public access to the new development.

The owner claims the rancher cannot use the easement for daily residential purposes since his prescriptive use was occasional and agricultural.

Can the owner limit the frequency and purpose of the neighbor's use of the easement to the pre-subdivision usage?

Yes! The use of a prescriptive easement is **limited to the adverse use** which created the easement. [**Cushman** v. **Davis** (1978) 80 CA3d 731]

### Bona fide purchasers

After a neighbor continuously uses an owner's property for over five years without the owner's permission, an easement is established — even if the neighbor later ceases to use the easement.

However, whether an unrecorded easement by prescription will be enforced against a bona fide purchaser (BFP) who becomes the new owner of the burdened property is open to different interpretations.

On one hand, the courts have applied *public policy* to allow the BFP to take title free and clear of unknown, unobserveable and unrecorded easements. [**Mesmer** v. **Uharriet** (1916) 174 C 110]

Conversely, courts have also allowed the user to enforce the easement against a new owner who is a BFP since prescriptive easements are *created by use* and are not controlled by recording requirements. [**Jones** v. **Harmon** (1959) 175 CA2d 869]

A buyer is not considered a BFP if **physical conditions** on the property are present, such as a road or visible pipeline extending to the neighbor's property, since the improvements constitute *constructive notice* of the use. [**Rubio Cañon Land & Water Ass'n** v. **Everett** (1908) 154 C 29]

# Chapter 22 — Interference and termination of easements

*This chapter reviews the ways in which an easement may be eliminated by an owner of property burdened by the easement.*

**Burdens and benefits exceeded**

An owner of property benefitting from an easement allowing him to use a neighbor's property can enjoin any activity which interferes with his proper use of the easement. [Calif. Civil Code §809]

However, the *interfering activity* occurring within the parameters of the easement must actually interfere **with the intended use** granted by the easement.

For example, a neighbor who owns adjacent real estate has the right to use an easement across an owner's property for ingress and egress to the neighbor's property from a public road.

The owner places improvements in the form of water tanks and grapevines on his property within the legal description of the easement, but not on the actual roadway used for ingress and egress. The improvements do not interfere with the neighbor's ability to access his property by use of the easement.

The neighbor claims the easement granted him the exclusive use of the entire area within the description of the easement and demands the removal of the tanks and grapevines.

In this situation, the improvements do not unreasonably interfere with the neighbor's ability to use the easement since the neighbor is able to continue using the existing roadway within the easement to access his property. Thus, the owner can continue to maintain water tanks and grow grapevines in the easement area, but not on the portion of the easement used by the neighbor for ingress and egress. [**Scruby** v. **Vintage Grapevine, Inc.** (1995) 37 CA4th 697]

Consider an easement across an owner's property which provides a neighbor with access to his property by a roadway within the easement. The neighbor entitled to use the easement constantly harasses the owner and his guests when they park cars within the legally described boundaries of the easement. The parked cars do not interfere with the neighbor's use of the roadway located within the easement.

The owner is unable to sell his property since the easement holder (neighbor) intimidates potential buyers.

The owner seeks to **extinguish the easement** and clear his title of this encumbrance, claiming he is unable to use the portion of his property which is subject to the easement because of the unreasonable conduct of the neighbor.

The neighbor claims his easement cannot be extinguished since his use of the easement does not permanently interfere with or exclude the owner from the easement or additionally burden the owner's property.

In this example, the easement cannot be extinguished. The harassment of the property owner by the neighbor is not a use of the easement. Thus, the **neighbor's harassment** does not increase the burden of the *intended use* of the easement for ingress or egress. [**Reichardt** v. **Hoffman** (1997) 52 CA4th 754]

## Termination of easements

An existing easement can be *extinguished*, and thus no longer affect the burdened property as an encumbrance on its title. Methods used to **extinguish** an easement include:

- *release* of the easement by a deed from the owner of the property holding the appurtenant right;
- *merger* by the acquisition of fee title to both the benefitting and burdened properties by the same owner;
- *destruction* of the burdened property which permanently prevents any further use of the easement;
- *forfeiture* due to the easement holder's abuse of his easement rights;
- *prescription* due to the burdened property owner's continuing interference with the easement; and
- *abandonment* by the conduct of the easement holder showing he does not intend to use his easement rights.

## Release by deed to burdened property

An owner of property benefitting from the use of an easement may voluntarily terminate the easement by **releasing the easement** to the owner of the property burdened by the easement.

The release can be accomplished by the use of a quitclaim or grant deed in favor of the owner of the property burdened by the easement and signed by the owner of the property with the appurtenant right to use the easement.

## Merger as an extinguisher

A **merger of legal interests** by common ownership of both the servient and dominant properties extinguishes an easement. A merger occurs when the same owner acquires fee title to both the benefitting and burdened properties.

Due to the fact that an owner cannot have an easement over his own property, the easement is automatically extinguished on the **common ownership** of both the properties. [CC §805]

However, no merger occurs when the sole owner of burdened property acquires title to the benefitting property as a co-owner since the owner is not the sole owner of both properties. [**Cheda** v. **Bodkin** (1916) 173 C 7]

Additionally, acquiring a lien which encumbers either the benefitting or burdened property by the owner of the other property is not a merger of interests.

## Extinguished by destruction of property

An easement is terminated by the **destruction** of the burdened property since nonexistence of the burdened property renders the use of the easement impossible.

Consider an easement to use a stairway in an adjoining building. When the building burns down, the easement is extinguished since the owner is not required to rebuild the stairway. [**Cohen** v. **Adolph Kutner Co.** (1918) 177 C 592]

## Forfeiture for exceeding authority

An easement is terminated by **forfeiture** when the easement holder exceeds his authorized use of the easement by placing an *excessive burden* on the property encumbered by the easement.

Consider a subdivider who owns land which entitles him to use a right-of-way easement over a neighbor's property.

Later, the subdivider divides his property into several residential lots. For access, he constructs a road on the neighbor's property within the legally described easement to a public road which opens the easement to use by purchasers of his lots and the public.

The neighbor claims the easement has been extinguished since the increased use of the easement by the buyers of the residential lots and the public creates an excessive burden on the property.

Is the right-of-way easement terminated by the increased use?

Yes! The increased use of the easement constitutes an excessive burden on the property it encumbers, and thus the easement is *extinguished by forfeiture*. [**Crimmins** v. **Gould** (1957) 149 CA2d 383]

The standards for forfeiture are vague and often left to the discretion of the courts to determine, on a case-by-case basis, whether the easement holder's actions create an undue hardship on the owner of the property burdened by the easement.

## Prescription creates and destroys

Just as an easement can be established by adverse use of another's property, an **easement** can be *extinguished* by the burdened property owner's use of the area within the easement which *permanently interferes* with his neighbor's ability to use the easement.

For example, a subdivider sells a parcel, granting the buyer a right-of-way easement for ingress and egress over an adjoining parcel he owns in the subdivision. Later, the subdivider constructs a concrete block wall on the adjoining parcel which blocks the buyer's use of the easement.

More than five years after the block wall was constructed, the buyer of the parcel benefitting from the easement seeks to quiet title to the right of way.

Is the easement terminated by the subdivider's unauthorized improvement which entirely blocked the use of the easement for more than five years?

Yes! The obstruction of the easement is an adverse use by the subdivider of the property burdened by the easement. Thus, the easement is extinguished since the subdivider interfered with the use of the easement for a period of five years. [**Glatts** v. **Henson** (1948) 31 C2d 368]

An adverse use for purposes of terminating an easement is any act by the burdened property owner which **permanently obstructs** the beneficial use enjoyed by the holder of the easement.

## Abandonment as never to use again

An easement can also be terminated through **abandonment** by the easement holder. However, the easement holder must clearly indicate his intent to **permanently abandon** the easement.

Consider a subdivider who grants a buyer of a parcel a right-of-way easement over an adjoining parcel owned by the subdivider. The buyer plants trees on his property blocking his access to his own easement over the adjoining parcel.

The subdivider later builds a fence between the parcels which further bars the buyer's access to the easement. The buyer makes a timely demand on the subdivider to remove the fence. The subdivider claims the easement has been extinguished by the buyer's abandonment of the easement, evidenced by the trees blocking access to the easement.

Has the buyer abandoned his easement by planting trees blocking his access to the right of way?

No! Mere **nonuse of an easement** is not sufficient conduct to demonstrate an easement holder's *intent to terminate* an easement by abandonment. The buyer's planting of trees which block access to the easement does not indicate he has decided to never use the easement in the future. [**Tract Development Service, Inc.** v. **Kepler** (1988) 199 CA3d 1374]

The termination of an easement by abandonment is not easily established. The easement holder's actions must demonstrate a **clear intent** to abandon all future use of the easement.

# Chapter 23 Covenants, conditions and restrictions

*This chapter discusses enforceable CC&R provisions, and reservations and restrictions in grant deeds.*

## Right-to-use limitations

The trees on a neighbor's lot have grown so tall that they obstruct a homeowner's ocean view from another lot in the subdivision. The homeowner, concerned about the loss of his view, checks the title restrictions recorded on the neighbor's lot for any height restrictions.

From the title restrictions, the homeowner determines:

- both his lot and the neighbor's lot are part of the **same subdivision**; and
- the original subdivision documents contain a restrictive provision limiting the **height of structures** located within the subdivision.

The homeowner requests his neighbor comply with the title restrictions by trimming his trees to conform to the height restriction on structures within the subdivision. The homeowner feels a reasonable interpretation of the subdivision height-of-structures restriction also extends to improvements in the form of trees.

The neighbor refuses to trim the trees, claiming the wording of the restrictive provision applies only to structural improvements and not to the trees growing on his lot.

Can the owner force the neighbor to trim his trees under the title restriction?

Yes! The neighbor must maintain his trees at a height equal to the height limitations imposed on all structures in the subdivision. One purpose of the structural height restriction is to protect the views of all owners in the subdivision. Title restrictions are enforced according to their intent. [**Ezer** v. **Fuchsloch** (1979) 99 CA3d 849]

The subdivision provision protecting the view of lot owners is classified as a *restrictive covenant.*

## Recording restrictive covenants

When developers subdivide land or airspace, they cut a plot of land into two or more horizontal or vertical sections, called *lots*, *parcels* or *units*. Having created a subdivision, developers place **restrictive covenants** on how the **lots** may be used by later owners, called *successors*.

**Use restrictions** are usually contained in a document called a *Declaration of Covenants, Conditions and Restrictions* (CC&Rs). **CC&Rs** are typically recorded with the original subdivision map.

Recorded documents in the chain of title to a parcel of real estate place a buyer on *constructive notice* of their contents. A prospective buyer of a home in a subdivision protects himself from unknowingly buying property burdened with unwanted restrictions by reviewing and approving (or disapproving) the preliminary title report (prelim). A prelim discloses the results of the title company's search of the property's title history.

The title company conducts the document search and prepares the prelim which functions as an offer to issue a title policy. As a customer service, they will supply copies of any CC&Rs of record on request.

Consider CC&Rs which are recorded on a subdivision during the subdivider's ownership of the property, before any of the newly created lots are sold. The grant deeds initially conveying lots to buyers and the later grant deeds transferring title of lots in the subdivision do not reference the recorded CC&Rs.

An owner who buys one of the lots violates the CC&Rs. The owner's neighbors in the subdivision seek to enforce the CC&Rs against the owner.

The owner claims the CC&Rs are unenforceable since they were not referenced in any grant deeds which transferred title to the property.

In this example, the CC&Rs are enforceable. The CC&Rs were recorded on the subdivision before any of the lots were sold. Thus, all purchasers of the lots are on **constructive notice** of the CC&Rs and must abide by them. [**Citizens for Covenant Compliance** v. **Anderson** (1995) 12 C4th 345]

A recording of the CC&Rs on the subdivision prior to any conveyance of any parcel fulfills the intent of the subdivider, and the expectations of future buyers, regarding the use of the parcels, lots and units within the subdivision.

### Covenants limiting use are affirmative

A recorded restriction can **limit the use** of a property to a specific purpose (e.g., a school, railroad, highway, dwelling, irrigation system, etc.). This type of restriction is classified as an *affirmative covenant*.

Another type of recorded restriction prohibits identified uses of the property, classified as a *negative covenant*. For instance, a typical **negative covenant** prohibits the sale of alcoholic beverages or other activities otherwise allowed to take place on the property.

For example, a neighbor in a subdivision seeks to restrain another owner in the subdivision from violating a restrictive covenant, similar to the previous example of a neighbor's trees exceeding the height restriction on improvements.

Can an owner of one lot enforce a restrictive covenant against an owner of another lot when the only relationship existing between them is ownership of a parcel, lot or unit within the same subdivision?

Yes! The right to enforce recorded subdivision restrictions transfers to the owners of each lot as part of the title to the property.

Further, the covenants, conditions and restrictions (CC&Rs) may provide for the property to revert to the original seller if the property is used in violation of a restriction. [**Romero** v. **Department of Public Works** (1941) 17 C2d 189]

### CC&Rs and future owners

Recorded covenants, conditions and restrictions (CC&Rs) bind future owners of the subdivided lots, a scheme referred to as covenants *running with the land*. For a covenant to **run with the land** and affect future owners, the restriction must **directly benefit** the property. Thus, all lots within the subdivision are burdened by the restriction. [Calif. Civil Code §1462]

Consider a restriction limiting the use of all subdivision lots to single family residences. The use restriction equally *benefits* and *burdens* each lot in the subdivision, assuring consistent and compatible use throughout the subdivision — a **benefit** with an advantageous effect on each property. Since it benefits every lot, the restriction **runs with the title** to each lot and affects all future owners. [**Miles** v. **Hollingsworth** (1919) 44 CA 539]

However, consider a subdivider who sells a beachfront lot while retaining ownership of the surrounding lots in the subdivision. The grant deed conveying the beachfront lot to the buyer contains a use restriction, stating the buyer can only conduct a hotel or yachting clubhouse business on the lot.

The buyer, unable to develop the property for the purposes set out in the use restriction, sells the lot to a developer who plans to use the property for a ferry landing service, not a hotel or clubhouse. The subdivider seeks to prohibit the developer from conducting a business which violates the restrictive use covenant in the recorded grant deed to the original buyer.

Can the subdivider enforce the covenant entered into by the original buyer and stop the developer from using the lot for a ferry service?

No! The use restriction provides **no benefit** to the beachfront lot since it merely imposes a burden on the original buyer who agreed to limit his use of the property. Also, enforcement of the restriction is further limited due to its lack of wording binding the buyer's **successors in interest** to the restrictive covenant.

The restriction is only enforceable as long as the buyer holds title. Thus, it is classified as a *personal covenant*. Since the restriction against use is a personal promise, it does not run with the land and cannot be imposed on the developer who reacquired title.

However, the subdivider is entitled to enjoin the developer if the developer's use of the property would *materially injure* the subdivider's remaining lots in the subdivision, such as depreciating their value. In this instance, the developer's intended use of the property as a ferry service would in no way **injure** the subdivider's remaining property, thus depriving the subdivider of entitlement to relief. [**Los Angeles Terminal Land Co.** v. **Muir** (1902) 136 C 36]

A restriction which does not run with the land and affect future owners is considered the grant of a **personal benefit** to the original owner or seller of the benefitted property, usually the seller who owns adjacent property. The owner of the property agreeing to the restriction on its use does not benefit from the restriction. It is a **personal burden** on the owner of the restricted property, not the property itself. A personal restrictive covenant is enforceable only against the persons agreeing to it, not future owners of the property, called *remote grantees*.

*Editor's note — Prior to 1968, for a covenant to run with the land, a common owner of two or more parcels had to reference the use restrictions in the grant deeds conveying title to the buyers. The relationship between the parcels descending from a common owner is called "privity of estate."*

*Restrictive covenants between owners whose property did not descend from a common owner could not run with the land until 1968. However, those restrictions were enforced against future owners as **negative easements**. [CC §1468]*

*Similar to a restrictive covenant, a **negative easement** permits a person, usually the original owner or seller of a parcel, to limit a new owner's use of that parcel. Although it was unenforceable as a restrictive covenant, a negative easement was enforceable — the new owner being subject to the same burden as the prior owner of the property. [**Bryan** v. **Grosse** (1909) 155 C 132]*

## Unenforceable or unreasonable CC&Rs

A subdivider sells "exclusive" residential lots with a deed restriction prohibiting the sale of lots to persons of a certain race or religion. Later, a member of the excluded race purchases and occupies a lot within the subdivision.

A neighbor attempts to invalidate the sale. The neighbor claims his rights under the subdivision plan have been violated since he purchased the lot subject to the restriction granting him the right not to live next to a person of the excluded race.

Can the neighbor enforce the race restriction?

No! Race restrictions violate federal civil rights laws and are unenforceable. Restrictions may not be imposed for unlawful purposes. [**Shelley** v. **Kraemer** (1948) 334 US 1]

*Editor's note — California prohibits any restriction on the basis of race, national or ethnic origin, ancestry, sex, marital status, sexual orientation, religion or disability in a conveyance of any interest in real estate. [CC §§53, 782]*

Additionally, restrictions on selling, leasing or encumbrancing real estate may not unreasonably restrict the marketability of the property, even if the restriction is contained in a trust deed or lease agreement. [CC §711]

However, due-on-sale clauses contained in a trust deed are no longer controlled by California law and, under federal mortgage law, are enforceable on the transfer of any interest in the real estate, except:

- short-term leases up to three years not coupled with a purchase option; and
- intra-family transfers of one-to-four unit, owner-occupied residential property on the death of an owner or for equity financing. [12 Code of Federal Regulations §591.5(b)]

Additionally, the assignment of a nonresidential lease may be restricted by a clause in the lease allowing the landlord to terminate the lease upon mere notice of the tenant's intent to assign the lease as provided under a separate **consent to assignment** clause. [**Carma Developers (California), Inc.** v. **Marathon Development California, Inc.** (1992) 2 C4th 342]

Covenants, conditions and restrictions (CC&Rs) on the installation or use of a solar energy system are unenforceable if the restrictions significantly increase the cost of the system or decrease its efficiency by:

- resulting in more than a 20% increase in the installation cost of the system; or
- decreasing the operating efficiency of the solar system by more than 20%. [CC §714]

## Covenants restricting transferability

Government agencies are given a broader standard of reasonableness for enforcing restrictions on resales, if implemented to promote a public policy.

For example, an owner of coastal real estate obtains a coastal development permit by recombining 77 lots into two parcels and recording restrictions which prohibit the later division of the two recombined parcels.

To protect the public interest in costal areas, a deed is recorded giving notice that a resale of an individual lot within the two recombined parcels will subject the owner to penalties under the Coastal Act, a

restraint on alienation. No official map is recorded which reverts the lots into acreage consisting of two parcels.

An investor purchases 54 of the deed-restricted lots and sells them individually to buyers in defiance of the resale restriction.

In this example, the investor is required to pay the maximum in fines allowed under the Coastal Act since the sale of individual lots is a violation of the deed restrictions imposed by the coastal development permit. Also, the investor is ordered to rescind the sale of the individual deed-restricted lots to the buyers to protect the public from further violations of the Costal Act. [**Ojavan Investors, Inc.** v. **California Coastal Commission** (1997) 54 CA4th 373]

## Amending CC&Rs

When circumstances affecting the use of lots in a subdivision have changed and the covenants, conditions and restrictions (CC&Rs) need to be altered, a provision for adding or removing covenants, called an *amendment clause*, usually exists in the originally recorded CC&Rs which establishes a procedure for making the change.

For example, a condominium association's CC&Rs usually can be amended by a majority or other percentage vote of the association members as set forth in the amendment clause in the association's CC&Rs. [**Diamond Bar Development Corporation** v. **Superior Court of County of Los Angeles** (1976) 60 CA3d 330]

**Unlawful restrictive covenants** in the CC&Rs for common interest developments (CIDs) can be removed from title under a program available through the California Department of Fair Employment and Housing (DFEH).

The DFEH's **Restrictive Covenant Identification Service** (RCIS) reviews deeds, declarations and CC&Rs sent to them by associations for CIDs to determine if they contain unlawful restrictive covenants, such as those based on race, color, religion, sex, familial or martial status, sexual orientation, disability, national origin or ancestry.

Upon receiving an application and the document containing the restrictive covenant in question, the DFEH reviews the language in the document. The DFEH then issues a written determination as to whether the identified language violates fair housing laws.

If the DFEH determines the language constitutes an unlawful restrictive covenant, the property owner may strike out the unenforceable language by recording a modification of the CC&Rs with the county recorder.

However, the RCIS procedure is not available to owners of individual units in a CID since the CID association must act on its own. The board of directors of a CID association is required to delete any unlawful restrictive covenants from its CC&Rs and governing documents without the need to first obtain either the approval of their owners or the DFEH. [CC §1352.5]

## Changed circumstances avoid CC&Rs

A seller of property restricts its future use to residential purposes when it is conveyed to a buyer. Five years later, the road in front of the property is enlarged to a four lane thoroughfare and the property is rezoned for commercial use.

The buyer wants to develop the property for commercial use compatible with the surrounding area.

Can the buyer develop the property for commercial use regardless of the covenants, conditions and restrictions (CC&Rs) limiting the property to residential use?

Yes! Due to *changed conditions* in the area surrounding the restricted property, the restrictive covenant is no longer enforceable. If conditions in the area near the property have changed so drastically that a covenant can no longer serve its *intended purpose*, it is unenforceable under the doctrine of **changed conditions**. [**Key** v. **McCabe** (1960) 54 C2d 736]

Consider an owner of a parcel subdivided into lots which are sold subject to CC&Rs restricting the use of each lot to one single family dwelling. Also, structures are required to be set back a minimum distance from the adjoining lots. However, a number of lots in the subdivision have been improved with more than one residential unit in compliance with local zoning and use ordinances but in violation of the set-back requirement of the CC&Rs.

The owner obtains a building permit and begins construction of a rental unit on his lot, in violation of the CC&Rs.

A neighbor in the subdivision seeks to halt construction, claiming the second dwelling unit on the property violates the one-house and set-back restriction in the subdivision's CC&Rs.

The owner claims the CC&Rs are unenforceable since a number of lots in the subdivision already violate the one-house and set-back restriction, and thus the conduct of the neighbors indicate an abandonment of the CC&R restrictions.

Can the neighbor stop the owner from constructing the second unit in violation of the CC&Rs?

No! Lack of uniform observance and enforcement against prior violations of the CC&Rs by other owners in the subdivision render the CC&Rs unenforceable. [**Bryant** v. **Whitney** (1918) 178 C 640]

### Environmental restrictions for personal benefit

A recorded covenant limiting the use and maintenance of hazardous materials is entered into by the owners of a property for the benefit of neighboring property owners, but not for the benefit of the property encumbered by the covenant. The covenant will **run with the land** and be enforceable against the present and future owners of the property by the other property owner's named as beneficiaries in the covenant, provided:

- the property burdened by the covenant is described in the document containing the covenant;
- the covenant is necessary to protect human health and safety due to hazardous materials; and
- the documents containing the covenant are recorded with the county recorder and entitled "Environmental Restriction." [CC §1471]

# Chapter 24 — Private road maintenance costs

*This chapter reviews an owner's obligation to share in the maintenance and repair of private roads.*

### Repairs: who pays and how much?

Several homeowners share a private road located on an easement for ingress and egress to their residences. The private road is in need of repair.

Who is responsible for the cost to repair and maintain the private road?

All the easement owners share the responsibility to repair and maintain the road. [Calif. Civil Code §845(b)]

However, the following issues arise when considering the repair and maintenance of a private road used by others:

- who has the responsibility of maintenance;
- allocation of costs, by agreement or arbitration;
- secondary easements for maintenance on adjoining properties; and
- responsibilities of the owner of property burdened by a road easement.

### Maintenance responsibility

A large development, such as a condominium project or other common interest development (CID), includes maintenance provisions in their covenants, conditions and restrictions (CC&Rs) to authorize centralized management to perform necessary repairs and maintenance of commonly used roads and driveways and assess the co-owners for their share of the costs.

Owners of property having appurtenant easements and persons holding easements in gross are allowed to use another's property. Consequently, they have the **duty to maintain** the easement they hold on that property. An owner of property with a private right-of-way easement across an adjacent property is responsible for maintenance of the right of way, not the owner of the adjacent property burdened by the easement. [CC §845(a)]

Owners of separate parcels who are entitled to use the same appurtenant easement may enter into an easement maintenance agreement. No standard maintenance agreement form exists.

If any owner fails to contribute under the maintenance agreement, the other owners must make a written demand on the easement user who defaults before taking legal action for reimbursement. [CC §845(b)]

When a written maintenance agreement does not exist between the holders of the easement and the owner of the burdened land, **maintenance costs are shared** in proportion to each users' use of the easement. [CC §845(c)]

Any one of the easement owners may apply for a court arbitrator to apportion the maintenance costs if the easement holders cannot reach an agreement. [CC §845(c)]

The maintenance and repair of an easement which is appurtenant to parcels owned by different owners includes the cost of **snow removal**, if snow removal:

- is not excluded from the maintenance and repair agreement;
- is necessary to provide access to the properties by way of the easement; and
- is approved by a vote of the property owners as called for in their maintenance agreement. [CC §845]

## Sharing maintenance and repair costs

The maintenance and repair of a road requires keeping it useable and in its historic condition. This is different from improving a road, which entails upgrading it from its historic condition.

Although all owners of property who use an easement must share in the costs of maintaining the easement, no owner who **further improves** the easement can force nonconsenting owners to contribute to the costs of the further improvements. [**Holland** v. **Braun** (1956) 139 CA2d 626]

Determining the mathematical formula to set each neighbor's percentage of their beneficial use of an easement is difficult. Each neighbor travels a different distance on the road depending on where along the easement his property is located.

Additionally, some will travel the road more frequently than others. Some may ride motorcycles or drive compact cars which create less wear and tear on the road than large trucks, SUVs or vans.

Some owners of parcels entitled to use the appurtenant easement may not even use it. However, the existence and condition of the easement are factors that affect the value of the parcel.

Due to the variable circumstances surrounding each users' actual use of an easement, an approximation of each easement holder's percentage of use is the best mathematical allocation method available.

For instance, two brothers buy separate portions of their parents' farm. One brother's property is granted an easement across the other brother's property for use as a private road leading to the public highway.

For many years the brothers peacefully share the use of the right of way. Eventually, the brothers come to a disagreement about who should maintain the right of way and how to split the maintenance costs.

Nothing in the easement grant specifies how the repair and maintenance expenses should be divided.

The brother using the road to access his farm at the rear travels a greater distance from the public highway than the other brother. Thus, he should pay a larger percentage of the costs.

An exact distribution of costs and labor is impossible to achieve among users of a private right of way. The approximation reached is 60% for the brother located off the highway and 40% for the brother on the highway. The allocation of costs is determined by the distance each brother travels on the road as a percentage of the total distance traveled by all uses. [CC §845(c)]

## Allocation by arbitration

If co-owners of an easement cannot agree on the allocation of costs for repair and maintenance of a private road, an arbitrator will be appointed by the courts. The repairs can be performed before or after the arbitrator is requested. [CC §845(c)]

An arbitrator's decision can be contested by any of the co-owners of an easement. However, the court then enters the arbitrator's award as a money judgment. If the award is contested by any of the co-owners, the court can enter a judgment which sets the liability of each owner in an amount proportionate to their use of the easement. The money judgment may be enforced by any co-owner against a defaulting co-owner. [CC §845(c)]

A court-appointed arbitrator can divide maintenance and repair costs equally, by the **distance** between an owner's driveway and the public road, or by **frequency** of use. [**Healy** v. **Onstott** (1987) 192 CA3d 612]

In calculating the apportionment of maintenance costs, an arbitrator should take into account which residences are and which residences are not occupied year-round. [Healy, *supra*]

Co-owners of a right-of-way easement may not be compelled to help pay for the cost of improving a road beyond its historical condition without their consent.

For example, a dirt road covered by an easement has fallen into disrepair. Some of the easement owners widen the road, grade it, install culverts and cut trees along its borders. They then demand contributions from other owners who did not consent to the improvement. The other owners refuse to contribute more than the cost of repair and maintenance of the existing dirt road, claiming the easement was upgraded from its historic condition.

The improvements did not merely repair the old road, but built it up to the extent that it was a new and different road located at the site of the historic road. The nonconsenting neighbors are not responsible for the **costs of upgrading** the road improvements. [Holland, *supra*]

### Secondary easements for maintenance

In order to keep an easement in repair, a user of the easement or his contractors may need to enter a neighbor's property to maintain the easement. *Secondary easements* on the property abutting the easement allow an easement user to enter a property for maintenance purposes so the easement may be used.

For example, an easement user places posts and reflectors along the edge of a narrow steep right of way to prevent cars from going over the embankment.

The owner of the property subject to the easement removes the posts. The property owner finds them inconvenient even though they do not interfere with his use or enjoyment of his property or road.

However, an easement gives users of the easement the right to do what is necessary to maintain the safe use of the easement.

Due to the fact that the road abuts a steep embankment, the posts and reflectors are reasonably necessary and not a needless burden on the property owner. Thus, the property owner has to replace the posts created on his property by the user of the easement. [**Herzog** v. **Grosso** (1953) 41 C2d 219]

Consider a group of landowners who grant an easement over a road to the county for use as a public highway. Without permission from the landowner, county officials bore a well on the highway to obtain subterranean water for watering the landscaping.

Although the well does not interfere with road usage, it is not necessary to maintain the road by watering the landscaping.

The easement is for a right of way only. The county does not have the right to drill wells on the landowners' property since watering the landscaping is not necessary in keeping the road easement in repair. [**Wright** v. **Austin** (1904) 143 C 236]

## Taking title subject to an easement

An *easement in gross* is a personal right to use another's property, such as a hunting easement. It is held by an individual and is not a right appurtenant to the title to any property he may own. The easement in gross, being a personal right only, will not remain with any property the holder of the easement may own and will not run with that property when the owner sells it.

An *appurtenant easement* is a right to use another's property which *runs with the land*, not the owner. Even though an appurtenant easement is located on neighboring property, it is transferred with the sale of the property it benefits since an appurtenant easement remains with the property. [CC §1104]

A right-of-way easement is transferred along with the conveyance of the property it benefits unless it is excepted under the terms of the conveyance. [**Lemos** v. **Farmin** (1932) 128 CA 195]

Lenders sometimes have special requirements when lending funds on property which holds a right-of-way easement for ingress and egress.

Loan appraisers and underwriters want a written maintenance agreement for the easement. In the absence of a written agreement, the buyer may be asked by the appraisers or underwriters to acknowledge he is aware of no written agreement.

If the right of way is to be repaired as a condition to closing a sale on a parcel benefiting from the easement, payment of the repairs needs to be worked out between the seller and the other users of the easement.

Lenders often require private rights of way be useable in all types of weather. Also, many lenders want the right of way to be consistent with other roads in the area. If the easement road is dirt and most of the roads in the area are paved, the lender may consider the property less valuable than a comparable property with a paved road.

# Chapter 25 — A deed as a transfer

*This chapter covers the creation, delivery and voidablility of a deed.*

### Elements of a valid conveyance

An owner signs a grant deed and acknowledges his signature as a *grantor* before a notary public. The notary public notarizes the deed so it will be accepted for recording by the county.

The deed conveys the owner's real estate holdings to one of his children, identified in the grant deed as the *grantee*. The real estate described in the deed includes the owner's personal residence and income-producing properties. The deed is **absolute** on its face, since it does not contain *conditions* or *reservations* to the grant.

The deed is then **handed** to the **grantee**, one of the owner's children. At the owner's oral request, the grantee agrees to hold the deed unrecorded until the owner's death, at which time the deed may be recorded.

The owner and the grantee both occupy the personal residence and the owner continues to collect rents, pay taxes and manage his income-producing properties.

Later, the owner advises his other child that the grantee is only entitled to the rents from the income properties after his death and only for as long as the grantee's need for the income exists.

The owner dies and the deed conveying the real estate is recorded by the grantee.

The grantee sells one of the income-producing properties. The owner's other child seeks to recover the proceeds from the sale of the property on behalf of the owner's estate, claiming the sales proceeds are part of the estate since the owner's oral statements limited the grantee's ownership interest to the rents only. The other child and the grantee share equally in the deceased owner's estate under the will.

The grantee claims he became the fee owner of the property when the owner handed him the deed, which constituted *delivery*.

Did the grantee become the owner of the property on delivery of the deed conditioned on his oral promise not to record it?

Yes! When the owner hands the deed to the sole named grantee, **delivery** occurs and absolute ownership of the property **immediately passes** to the grantee. The deed contained no written reservation of a life estate on the owner nor placed any condition on the grantee's ownership of the fee interest conveyed.

The **oral conditions** placed on the recording of the grant deed are not enforceable since delivery of a deed to the grantee cannot be subjected to an oral condition. Only written conditions expressed in the deed itself are enforceable when the deed is handed to the grantee. Thus, oral conditions cannot alter, add or subtract from the contents of the deed. [**Blackledge** v. **McIntosh** (1927) 85 CA 475]

Further, an owner delivering a grant deed to the grantee named in the deed cannot orally reserve for himself a life estate in the property unless the condition is written in the deed as a *reservation* to limit

the interest conveyed. Also, the owner's continued possession and management of the property is insufficient to show an intent to reserve a life estate. [**Lewis** v. **Brown** (1913) 22 CA 38]

If an owner does not intend for his deed to take effect immediately, he must state so in writing in the deed he hands to the grantee, keep the deed to himself or deposit it with a third party, such as an escrow, along with instructions when to use it.

### A deed by any name is a grant

Real estate is *conveyed* when title is transferred from one individual to another. [Calif. Civil Code §1039]

The transfer of title to real estate contained in a writing is called a *grant* or *conveyance*, no matter the form of writing. [CC §1053]

A *deed* is itself the **grant** which transfers title to property. [**Hamilton** v. **Hubbard** (1901) 134 C 603]

### Title by deed passes either:

- *voluntarily* by agreement with the owner, as in a sale in the open market, or under a power of sale provision in a trust deed or the covenants, conditions and restrictions (CC&Rs) of a common interest development (CID); or
- *involuntarily* without agreement, as in the enforcement of a creditor's judgment or tax lien.

No matter the form of writing, the individual conveying real estate is called the *grantor*, and the individual acquiring title is called the *grantee*.

*Fee simple ownership* is presumed to pass by a grant of real estate, unless a lesser possessory interest is stated, such as an easement, life estate or leasehold interest, or a quitclaim deed is used. [CC §1105]

Ownership of *possessory interests* in real estate include:

- a fee simple;
- a life estate;
- a leasehold estate; and
- an estate at will. [See Chapter 7]

A **fee simple** interest in real estate is the absolute ownership of the possessory rights in the real estate for an indefinite duration.

Consider an owner who executes a grant deed which states the grantee is to hold ownership of the property until the grantee's death. On his death, the property is to revert back to the owner or the owner's heirs or successors.

Does the grantee receive a fee simple estate since a grant deed was used as the form of writing?

No! The grantee was conveyed only a *life estate* in the property since he was not given absolute ownership of the real estate for an indefinite period. Instead, the deed restricted the grantee's ownership to the right of possession for the duration of the grantee's lifetime only. [**Whitcomb** v. **Worthing** (1916) 30 CA 629]

## Creating a valid deed for conveyancing

To be *valid*, a deed must:

- be in writing;
- identify the grantor and the grantee;
- contain a granting clause stating the grantor's intention to convey;
- adequately describe the real estate involved;
- be signed by the grantor; and
- be handed to and accepted by the grantee.

Form deeds used in real estate transactions conform to these validity requirements by containing words of conveyance, and contain provisions for the identification of the parties and a description of the real estate. They are also of suitable size and format to permit the deed to be notarized and recorded. [See **first tuesday** Forms 404 and 405]

## A deed in writing, with exceptions

To be **valid**, the *transfer* of an ownership interest in real estate must be in writing, except for:

- an estate at will or a lease not exceeding one year [CC §1091];
- an *executed* (partially or fully performed) oral agreement under which the buyer takes possession of the property and makes payments toward the purchase price or makes valuable improvements on the property; or
- adverse possession.

An **executed oral agreement** for the transfer of real estate ownership will be enforced either under the doctrines of *specific performance* or *estoppel*. The application of both doctrines is unaffected by whether the property is being sold under an oral agreement to a buyer for consideration, or given to a **donee** by gift.

## Enforcing an oral promise to convey

A buyer and seller who enter into an oral **land sales contract**. The buyer agrees to pay the purchase price by taking over payments on the first trust deed of record and making monthly payments to the seller.

The seller agrees to convey title to the buyer when the buyer has fully paid the purchase price, resulting in the satisfaction of the first trust deed and the complete payoff of the seller's equity in the land sales agreement.

The buyer takes possession of the property. The buyer eventually completes payment of all amounts due to the first trust deed lender and the seller under the land sales contract. Having fully performed the oral agreement, the buyer makes a demand on the seller to convey title to the property.

The seller refuses, claiming the oral land sales contract is unenforceable since the statute of frauds requires an agreement for the sale of real estate to be in writing to be enforceable.

Is the buyer entitled to the specific performance of the oral land sales contract and conveyance of title to the property?

Yes! The buyer's **possession** of the property and **full or partial performance** of the oral land sales contract collectively acts as a substitute for the prerequisite signed writing required by the statute of frauds for enforcement of a sale of real estate.

However, **partial payment** of the purchase price under an oral agreement when the buyer is not given possession is insufficient to overcome the statute of frauds writing requirement for an agreement transferring real estate.

The buyer must be given possession of the property for the oral purchase agreement to be enforceable on a partial payment. The buyer's **open and notorious** possession indicates a claim of ownership in the property which is inconsistent with the seller's claim of ownership when a verbal agreement for payment of the agreed-to price has been acted upon. [**Francis** v. **Colendich** (1961) 193 CA2d 128]

Additionally, the buyer's possession of the property is inconsistent with record title. Any purchaser obtaining title from the seller (or lender receiving a trust deed lien) after the buyer takes possession is on *constructive notice* to further inquire into the interest of the buyer-in-possession of the property.

The subsequent purchaser (or lender) will not be an innocent buyer who is without notice of the buyer-in-possession's interest, called a *bona fide purchaser* (BFP), since the purchaser (or lender) must inquire about the buyer-on-possession's interest when it appears inconsistent with the his recorded interest, if a recording exists. [**Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356]

## Unjustly enriched unless estopped

Consider an owner of real estate who **orally conveys** all his interest in a vacant parcel of real estate to his son as a gift. The son takes possession of the property and makes substantial improvements on it, including the construction of a building. The value of the property added by the construction exceeds the fair rental value of the son's possession before completion of the construction.

Later, the owner dies. Other heirs under his will make a claim to an ownership interest in the improved property. The son seeks to quiet title to the property in his name, claiming he took possession and made substantial improvements to the property in reliance on the owner's gift of the real estate to him.

The heirs claim ownership to the property was not conveyed since the owner did not transfer title to the property by a signed writing.

Do the heirs have an ownership interest in the property orally conveyed to the son as a gift?

No! The heirs are barred, called *estopped*, from denying the son's claim of ownership by asserting a written conveyance must be signed by the owner as required by the statute of frauds. To now require a writing to evidence the gift will *unjustly enrich* the heirs, due to the value added by the improvements, and place an *unfair burden* on the son.

The son **took possession** of the property in reliance on the owner's oral conveyance as a gift, and later placed **substantial** and **permanent improvements** on the property. To deny the son title to the property after he built the substantial improvements would be *inequitable* and unfair. Thus, the equitable *doctrine of estoppel* will not allow the writing requirement in the statute of frauds to be used by challengers to defeat the gift made by an oral conveyance of the real estate. [**Green** v. **Brown** (1951) 37 C2d 391]

However, the expenditures and improvements on the property must provide **lasting benefits** and enhance the property's value beyond its mere rental value. Slight or temporary improvements by occupants who

claim ownership under an oral conveyance are not sufficient to quiet title in the occupant and defeat a challenge based on the need for a writing under the statute of frauds.

The value of the improvements made by the occupant-in-possession of a property in reliance on an owner's oral conveyance must exceed the **fair rental value** for the possession and use of the property, such as to constitute a capital investment by the occupant. Without an investment exceeding the rental value, no basis exists to support enforcement of the oral conveyance and **estop** others who wish to deny the occupant's ownership for the lack of a written conveyance. [**Burris** v. **Landers** (1896) 114 C 310]

### Title by claims of adverse possession

To establish title by *adverse possession*, an occupant must show:

- his possession is based on a *claim of right* or *color of title*;
- he has occupied the property in an open and notorious way which constitutes *reasonable notice* to the record owner;
- his occupancy is *hostile and inconsistent* with the owner's title;
- he has been in possession for a *continuous and uninterrupted period* of at least five years; and
- he has *paid all taxes* assessed against the property during his occupancy. [Calif. Code of Civil Procedure §§318 et seq.; see Chapter 21]

An occupant's ownership by **adverse possession** based on a **claim of right** avoids the statute of frauds requirement that agreements to transfer real estate must be in writing.

To obtain title by adverse possession based on a claim of right, the occupant has, by the nature of adverse possession, no written documentation or evidence of title. Essentially, the adverse possessor is a trespasser in possession of the owner's property without any bona fide (good faith) belief he holds title to the property. [**Brown** v. **Berman** (1962) 203 CA2d 327]

Thus, in the case of adverse possession by a claim of right, the owner of the property has not orally conveyed title to the real estate to the occupant. The occupant is a trespasser until his **conduct** and **time in possession** meet the requirements for him to obtain a court ordered transfer of title by adverse possession.

On the other hand, title by adverse possession based on a **color of title** usually occurs when the occupant's title is based on a defective deed.

For example, a son forges his father's signature on a power of attorney form naming the son as his father's agent, called an *attorney in fact*. Using his authority under the power of attorney, the son sells the father's property, signing the grant deed conveying title to the buyer as his father's **attorney in fact**.

The buyer of the property, unaware of the son's forged authority, accepts the deed. The buyer takes possession of the property and conducts himself as the owner of the property, including paying the property taxes.

More than five years after title and possession of the property is delivered to the buyer, the father learns of the forged grant deed and seeks to eject the buyer from the property and clear (quiet) title of the cloud created by the forged deed (which is void).

Does the buyer hold title to the property by adverse possession — even though the deed of record is forged and void?

Yes! Although the buyer's deed was void due to the forged power of attorney, the buyer's possession was sufficient to put the true owner, the father, on notice of the buyer's claim. Since the buyer's conduct meets the requirements of adverse possession, including the payment of property taxes, the buyer is entitled to title by adverse possession based on his *color of title* as a defense against the father's attempt to recover the property. [CCP §§322, 323]

### Grantor qualifications as capable

A **grantor** of property must be *capable* of conveying an interest in real estate at the time the deed is signed for the deed to be enforceable as an actual conveyance of real estate. [CC §38; Calif. Family Code §6701]

To be **capable**, the grantor at the time the deed is signed must:

- be of *sound mind*;
- possess his *civil rights*; and
- be *an adult* at least 18 years of age. [CC §1556]

However, an exception exists to the "18 or over" age qualification. An individual under the age of 18 is considered an adult as an *emancipated minor* if the individual:

- has entered into a valid marriage, even if the marriage is now dissolved;
- is on active duty with the United States armed forces; or
- has received a declaration of emancipation from the court. [Fam C §7002]

An **emancipated minor** is considered an adult capable of transferring an interest in real estate. [Fam C §7050(e)(3)]

Consider a **temporary conservator** who is appointed by the court to manage the affairs of a property owner when the owner is found to be of *unsound mind* and unable to care for himself. Later, the owner, without court approval, deeds his property to a friend.

The conservator seeks to set aside the owner's deed to the friend.

The conservator claims the deed is **voidable** since the temporary appointment of the conservator establishes that the owner lacks the legal capacity to deed property. The friend claims the appointment of the temporary conservator did not affect the owner's legal capacity to convey his real estate.

Is the owner legally capable of conveying his property to his friend when he is subject to a temporary appointment of a conservator?

No! The appointment of a temporary conservator is a determination by a court that the owner lacks the legal capacity to convey real estate. Thus, the deed is voidable and can be set aside as void since the owner is *legally incapable* of conveying property from the moment a temporary conservator has been appointed until the conservator is discharged. [**O'Brien** v. **Dudenhoeffer** (1993) 16 CA4th 327]

To put the public on notice of a conservatorship, a *notice of conservatorship* is recorded in the county where the property is located. Unless the notice is recorded, the owner's conveyance to an individual who does not have **actual knowledge** of the conservatorship is valid. [Calif. Probate Code §1875]

However, while the deed may be valid, the failure to record a **notice of conservatorship** does not eliminate the *rules of equity* when the incapable owner has conveyed property. A conveyance to a buyer who does not have actual or constructive knowledge of the conservatorship may be *rescinded* (set aside) as

voidable by the owner if he did not understand the nature and consequences of the sales transaction when he entered into it. [Prob C §§1875, 1876]

Further, if a court not only decrees an owner to be **incompetent** but appoints a *guardian* as well, any later conveyance of real estate by the owner is void as having transferred nothing, not merely voidable. When the owner has been adjudicated as entirely incompetent and is appointed a **guardian**, a later conveyance by the owner can be set aside as never having been effective, even if the grantee is a bona fide purchaser (BFP) for lack of actual or recorded notice of the guardianship.

The appointment of a guardian and decree of incompetency, even unrecorded, is considered notice to all individuals of the owner's legal incapacity to convey real estate under any circumstances.

Unlike the appointment of a conservator, a **guardian** does not need to record a notice of the appointment to put buyers and lenders on notice. A court's determination of the owner's incompetence and appointment of a guardian constitutes *notice to the world* that the deed is void since the owner lacks all legal capacity to convey property. [**Hellman Commercial Trust & Savings Bank** v. **Alden** (1929) 206 C 592]

## Incompetency before court ruling

Consider an owner who conveys real estate before a court rules him incompetent. For the conveyance **to be void** and thus entirely unenforceable by the grantee, the owner must be incompetent as entirely without understanding on all matters when the deed was signed. [CC §38]

However, if the owner simply lacks an understanding of the nature and the consequences of the transaction but is not completely without understanding and has not been appointed a guardian, the conveyance may be merely **voidable**. Thus, the deed must be later rescinded by the owner to void its continued validity. [CC §39]

In the instance of an incompetent owner not entirely without understanding, if the grantee can show he was unaware of the owner's incompetency at the time of the conveyance and provided valuable consideration, the conveyance is enforceable. [Calif. Prob C §1875]

## Grantor identification in deed

The *grant provision* in a deed must identify each person who is conveying an interest in the property. If a conveyance such as a deed is signed by a person who is **not named as the grantor** in the grant provision in the deed, the deed does not convey that person's interest in the property. The identity of the grantor in the provision containing words of conveyance (grant) must be certain by an examination of the entire deed, not just the signatures. [**Childs** v. **Newfield** (1934) 136 CA 217]

For example, a deed identifies several individuals as grantors in a grant provision and the document contains their signatures. However, the list of grantors named in the deed's grant provision is incomplete and does not convey all the fee ownership of the property since several unnamed individuals also have an ownership interest in the property.

Further, the signatures on the grant deed include all the individuals who are co-owners of the property — even though some are not named as grantors in the grant provision.

In this instance, the deed transfers only the ownership and title held by those owners named as grantors in the grant provision in the deed. The deed by its wording does not show the necessary intent to convey title by the unnamed owners who were not listed as grantors and also signed the deed. [**Roberts** v. **Abbott** (1920) 48 CA 779]

On recording, the county recorder will only index as grantors those persons listed in the grant provisions since only they conveyed their interests in the real estate.

## Grantor's vesting in the chain of title

The name of the grantor on a deed must match up with the name of the grantee named in the previous deed which conveyed title to him.

For example, an unmarried woman takes title in her maiden name "as an unmarried woman."

Later, the woman marries and takes her husband's last name as her own.

If the woman then conveys the property using her newly acquired married name to identify herself as the grantor, a **break in the chain of title** occurs. When a different name is used as the grantor from the name used to receive title under a prior deed, the new name cannot be located in the county recorder's grantor-grantee index as the grantee who previously received and holds title to the property being conveyed. Further, the title would remain in her maiden name as no one is on notice (by the record) of her conveyance.

With a break in title between deeds due to the grantor's name change after taking title as a grantee, a buyer will receive an unmarketable title. In this example, the grantor received title in her maiden name as an unmarried woman and conveyed the property in her married name, causing a break in the chain of title. [**Benson** v. **Shotwell** (1890) 87 C 49]

Any person conveying property whose name has changed after becoming vested in title must also as the grantor on the conveyance enter the name in which they previously received title to the real estate as a grantee. [CC §1096]

For example, for the woman who later marries, the deed can identify the grantor as *Mary Smith, who took title as Mary Jones, an unmarried woman, does convey...*

The identification of the woman's prior name links her in the recorder's indexes as both a grantee of record and the grantor under the present deed which conveys her "out of title."

Thus, the conveyance refers to both the name in which the grantor originally received title, and the name by which the same grantor is conveying the title.

When a deed does not identify the grantor by the precise name and spelling under which the grantor previously took title, the deed does not give constructive notice to later buyers or encumbrancers of the property that the grantor has already conveyed his interest. However, the deed with the reference to the incorrect name of the grantor is valid and enforceable between the parties to the deed and those who have notice of the true identity of the grantor. [CC §1096]

Further, **possession** of real estate by the grantee is *constructive notice* to others that the defective deed exists since possession places future buyers, lenders and tenants on notice to ask the grantee-in-possession what interest he has in the property.

## The grantee as any person

While the grantor must *have the capacity* to convey title, any existing person (individual or entity) may take and hold title to real estate as the *grantee.* [CC §671]

A child or an incompetent person has the *capacity to receive* and hold title as a grantee even though that person does not have the legal capacity to then convey the same property. [**Turner** v. **Turner** (1916) 173 C 782]

A deed must **identify** the grantee. For example, a seller accepts a buyer's purchase agreement offer. The seller concurrently signs a deed and hands it to the broker since the seller is leaving the country. However, the space for the name of the grantee is left blank. The broker is not instructed to enter the buyer's name as the grantee. The broker, as instructed, delivers the deed to the buyer without entering the buyer's name as the grantee.

Is the deed which does not name the grantee a valid transfer of title?

No! A deed which does not identify a grantee is void. The identity of the grantee must be sufficient to **identify with certainty** the individual to whom the seller intends title to be passed, such as by identifying the grantee as "the husband of the grantor." [**Tumansky** v. **Woodruff** (1936) 14 CA2d 279]

Consider a seller who places his grant deed in escrow (a third party) without naming a grantee or instructing escrow to enter a grantee's name.

Later, the escrow agent inserts the name of the buyer in the deed as the grantee on the assumption the deed was to be used to convey title to the buyer. The buyer's name is inserted without the seller being present or the seller's written authority.

Is the deed enforceable after escrow inserted the buyer's name in the deed without receiving the seller's authority?

No! If a seller/grantor is not present when a buyer's/grantee's name is inserted in the grant deed, or if the name of the grantee is inserted by a person without the grantor's written authority to do so, the deed is *void.* [**Tannahill** v. **Greening** (1927) 85 CA 714]

Additionally, a deed is considered valid if the individual identified as the grantee takes title under a *fictitious name* by which he is also known or has assumed for the purpose of receiving title.

However, if the fictitious name is established for the purpose of committing a fraud against the grantor, the grantor may set aside the deed as **voidable**.

A deed to a person who does not exist, referred to as a *fictitious person*, or to a person who is dead at the time of conveyance, or to a corporation, limited liability company (LLC) or partnership which does not legally exist, will not convey title since no one exists to accept delivery. [**McWhorter** v. **McWhorter** (1929) 99 CA 293]

Sometimes an unintentional error **misnames the grantee** in a recorded deed, such as by misspelling the grantee's name. A deed with a misnamed grantee is still a valid conveyance of the real estate.

Another deed from the same grantor to the grantee named with the correct spelling of the grantee's name will not correct the error, nor will re-recording the original deed with an amendment containing the grantee's correct name. The recording of a corrective deed falls outside the chain of title in the grantor-grantee index since the grantor no longer has any interest to convey. The grantor has already conveyed his title, albeit to a grantee with an erroneously spelled name. [**Walters** v. **Mitchell** (1907) 6 CA 410]

A grantor who has conveyed title cannot do so again even as an attempt to convey title to the same grantee.

*Editor's note — Title companies are only concerned the grantor on a deed is the same person who took title under the incorrect name. Title companies will generally accept a deed conveying title which identifies the grantor by both his correct name and the incorrect (misspelled) name under which he originally took title as a grantee.*

Conversely, consider a buyer who acquires title from a seller. The seller previously took title to the property as a grantee under a name different from the name the seller used to convey title to the buyer.

In this instance, the buyer may petition the court for an order stating the individual who conveyed title to the buyer is the same individual who previously acquired title to the property, even though the names used by the individual to take title as grantee and later convey title as grantor in the separate documents are different. The petition is for a *determination of the identity* of a person in the chain of title. [CCP §§770.010 et seq.]

## Corporations, partnerships and LLCs

A partnership, limited liability company (LLC), corporation and real estate investment trust (REIT) are *persons* who may acquire title to California real estate since they are entities established or qualified under California law to conduct business in the state. [Calif. Corporations Code §§207, 16203, 17003(f)]

Consider a seller who sells property to a corporation which at the time does not yet legally exist. Further, a deed is signed and handed to escrow by the seller, naming the corporation as the grantee.

The corporation files its articles of incorporation with the Secretary of State of California prior to the close of escrow. Later, escrow is closed and the deed is delivered (recorded) and accepted by the corporation.

Is the deed enforceable?

Yes! A corporation has the capacity to receive title to real estate even though the deed was signed before the corporation legally existed. A deed **becomes effective** on its delivery to the grantee, not on the date it was signed.

However, a deed will not be considered delivered if the corporation does not exist at the time of the deed's delivery to the corporation since acceptance by the grantee is required for a delivery. The deed is not considered accepted if the corporation, as the grantee, does not legally exist at the time the deed is recorded. Thus, the deed will only be effective if it is delivered after the corporation files its articles of incorporation, legally bringing it into existence. [**Wall** v. **Mines Girls' Directory Orphan Asylum** (1900) 130 C 27]

A corporation filing its articles of incorporation is evidence of the formation and existence of the corporation. [Corp C §209]

## Words of conveyance for a fee or less

The actual words of conveyance in a deed depend on whether the deed used is a *grant deed* or a *quitclaim deed*. [See Chapter 27]

A **grant deed** is used to pass a *fee simple interest* in real estate from the grantor to another individual, unless a lesser interest is stated in the deed. While no precise words of conveyance are necessary, use of the word "grant" in the granting clause, without noting a lesser interest in the description of the property, indicates the conveyance of a fee simple interest in the described property. [See **first tuesday** Form 404]

Alternatively, a **quitclaim deed** is intended to convey whatever interest, if any, the grantor may hold in the real estate. The words of conveyance historically used in a quitclaim deed are "remise, release and otherwise quitclaim."

However, only the word "quitclaim" is required as the word of conveyance. The word "grant" is not used in a quitclaim deed since no implied warranties are included with a conveyance under a quitclaim deed. However, the parties to a quitclaim deed are referred to as the "grantor" and the "grantee." [See **first tuesday** Form 405]

### The property description imperative

Two parcels of real estate owned by the same individual are situated on opposite sides of a public street. The city abandons the street by recording an **abandonment order** while the individual still owns both parcels of real estate.

Later, the owner conveys, by an **easement deed**, a 100-foot wide railroad right of way across the southern parcel. The deed conveying the easement states the 100-foot wide right of way is located south of and adjacent to the northern line of the southern parcel. No reference to the abandoned street is made in the easement deed.

The railroad places survey stakes along the northern line of the southern parcel to mark the northerly boundary of the right of way. The stakes for the northern boundary of the right of way are located on the south side of the abandoned street.

The owner of the northern parcel plants an orange grove on the entire abandoned street, north of the survey stakes for the northern side of the 100-foot railroad right of way.

The owner sells the northern parcel. The deed conveying the northern parcel describes the parcel by referencing the subdivision map and the city's abandonment order. Due to the orange grove being located on the entire abandoned street, the buyer of the northern parcel believes the property conveyed includes all of the abandoned street.

Later, the owner sells the southern parcel subject to the railroad's right of way and the city's abandonment order.

The buyer of the southern parcel then purchases the right of way easement from the railroad and eliminates the easement (by merger) from his record title.

The buyer of the southern parcel and the buyer of the northern parcel dispute the location of the common boundary between their properties. The buyer of the northern parcel claims his parcel includes the entire abandoned street since the orange grove is located on the abandoned street.

The buyer of the southern parcel claims title to the southern half of the abandoned street since the southern half of the abandoned street attached to the southern parcel on the abandonment by the city.

**Figure 1**

Example of the reference in a deed to the description of property located in other documents:

Lot 30 of the Sherman Tract #3 as per map recorded in Book 34, pages 72 of maps, records of Riverside County, California.

Is the southern portion of the street included as part of the conveyance of the southern parcel to the buyer?

Yes! The deed given to the buyer of the southern parcel includes the southern portion of the street since the southern half of the street became part of the southern parcel by *operation of law* when the street was abandoned by the city.

The title of property which is bordered by a street extends to the center of the street on the abandonment of the street. Title to the abandoned street is conveyed by a deed describing the parcel unless the grantor does not intend to convey the portion of the street and reserves it for himself in the deed. [CC §1112]

Since the deed to the buyer of the southern parcel included reference to the city's abandonment order of the street, the owner did not intend to reserve for himself the southern half of the street.

Thus, *extrinsic evidence* cannot be used, such as the existence of the orange grove, to show the deed conveyed the entire street with the northern parcel. The deeds conveying the parcels to the buyers are not ambiguous. Each **deed on its face** conveys the entire parcel as described in the subdivision map and the city's abandonment order with one half of the abandoned street to each the northern and southern owner. [**Baker** v. **Ramirez** (1987) 190 CA3d 1123]

## Describing the property conveyed

A deed conveying property must sufficiently describe the property being conveyed so it can be reasonably located from the description in the deed. If the property cannot be located from the description in the deed, the conveyance is void. [**Scott** v. **Woodworth** (1917) 34 CA 400]

**Extrinsic evidence**, facts not stated in the deed, may only be used when an **ambiguity** arises as to the description of the property conveyed.

However, extrinsic evidence may not be used to supply the deed with a missing description or correct a defective description.

The description of a parcel in a deed must be sufficient to allow the real estate conveyed to be identified and located with reasonable certainty by a surveyor. [**Best** v. **Wohlford** (1904) 144 C 733]

For example, real estate is conveyed by a deed describing the property as the "Occidental Mill Site, containing 4.95 acres, being a fraction of lot 2..." The use of the real estate's common name in the deed is sufficient to locate the boundaries and identify the real estate being conveyed. [CC §1092]

*Editor's note — Any dispute regarding the location of the 4.95 acres on lot 2 must be resolved as a* ***boundary dispute.***

Additionally, a deed which describes real estate by its street address, such as "879 Riverside Avenue, Riverside, CA 92507," will be considered sufficient to identify the real estate located at the street address, sometimes called a *common description* or *common address*. [**Brudvig** v. **Renner** (1959) 172 CA2d 522]

However, the deed should include the property's legal description (metes and bounds) or a map designation, such as a parcel or lot number, which contains the **metes and bounds** description needed to locate with certainty the parcel being conveyed.

Thus, the real estate can be described by reference to other documents, such as a subdivision map which contains the metes and bounds description of the parcel. The document referenced in a deed is incorporated into the deed as the source of the metes and bounds description of the property conveyed. [**Edwards** v. **Lewis** (1938) 25 CA2d 168; see Figure 1]

## The grantor's signature

To transfer real estate by a deed, the deed must be signed by the grantor named in the deed. [CC §1091]

A deed can also be signed on behalf of the grantor by the **grantor's agent** if the agent is authorized in writing to convey the property on the grantor's behalf. The agent is called an *attorney in fact* and is operating under a *power of attorney.* [CC §1091; see Chapter 15]

Additionally, a deed can be signed in the name of the grantor by an *amanuensis* as orally instructed by the grantor. An **amanuensis** is an individual who has the oral authority of the grantor to sign a grant deed by his own hand on behalf of the grantor.

Unlike an **attorney in fact** who is an agent with **discretionary authority** to determine whether he is to enter into a deed without prior approval from the grantor, an amanuensis has a purely ministerial duty and signs a document as instructed without exercising his personal discretion or judgment.

Consider an owner who prior to becoming blind executes a **power of attorney** naming his daughter as his attorney in fact. Under the power of attorney, the daughter has the power to sell, convey and transfer the owner's property as though she were the owner. However, an attorney in fact does not have authority to convey the property to herself or anyone else as a gift.

A grant deed is prepared for the owner's signature, conveying the property to his daughter as a gift. On the verbal instruction of the now-blind owner, the daughter signs the owner's name on the grant deed by her own hand. The deed is recorded and returned by the recorder to the owner.

The owner dies and his son seeks to set the grant deed aside. The son claims the grant deed is invalid since as an attorney in fact, the daughter does not have the authority to convey the property to herself as a gift.

The daughter claims the grant deed is valid since she signed the deed as an amanuensis on the instruction from the owner to sign his name on the deed and did not act in her capacity of an attorney in fact.

Is the grant deed signed by the daughter on behalf of the owner valid?

Yes! The deed is valid. When the daughter signed the deed, she was not acting as an agent but as an instrument of the owner. Thus, the daughter did not exercise her discretion as an agent of the owner acting under a power of attorney when the property was conveyed to her since she acted as an amanuensis. She followed the owner's oral instructions when she signed the owner's name to the grant deed. [**Estate of Stephens** (2002) 28 C4th 665]

*Editor's note — For a discussion on the differences between grant deeds and quitclaim deeds, see Chapter 27.*

# Chapter 26 Delivery, acceptance and validity of deeds

*This chapter discusses the intent necessary for a deed to be considered an enforceable conveyance which will withstand claims it is void or voidable.*

## Need for delivery, not a recording

A deed conveying real estate **transfers ownership** to the named grantee when the deed is *delivered*. The mere signing of a deed by the owner as the grantor, naming another person as the grantee to become the owner, is not enough to divest the owner of his title to the interest he holds in the real estate. Delivery of the signed deed is required to transfer ownership.

**Delivery** refers to two separate acts:

- the grantor's present **intent to convey title**, not just the act of physically handing the deed to the grantee; and
- the grantee's **acceptance** of the grant deed as an immediately effective conveyance.

While the grantor may intend to convey title when he hands over the deed, if the grantee **does not accept** the deed, the deed will not be considered delivered and a conveyance does not occur.

However, the grant deed does not need to be recorded to deliver title to a new owner or to revest title in two or more persons. Recording only *perfects* the ownership against third-parties, such as unknown off-record interests or later buyers, tenants and encumbrancers of the property.

For example, a mother, son and daughter hold title to real estate as joint tenants.

The mother and daughter sign a grant deed to their undivided two-thirds interest in the property and deliver it to themselves as joint tenants. The deed is not recorded but the daughter has possession of the deed.

The mother passes away and the son seeks ownership of a one-half interest in the property. The son claims the grant deed did not sever the joint tenancy which existed between the mother, daughter and himself since it was not recorded.

The daughter claims the son only holds a one-third interest in the property since joint tenants who execute a deed to one another do not have to record the deed to sever the joint tenancy they hold with another co-owner.

Is the son entitled to a one-half interest in the property as one of the surviving joint tenants?

No! The grant deed between the mother and the daughter severed their joint tenancy with the son since the deed only needed to be **delivered, not recorded**, to terminate the son's right of survivorship. Thus, the son owns no more than his original one-third interest in the property since he no longer is a joint tenant. The son became a tenant in common on delivery of the deed. [**Re** v. **Re** (1995) 39 CA4th 91]

## Constructive delivery inferred

The delivery of a deed is *inferred* when the grantee receives or has **possession** of the deed. The deed may also be considered delivered without the grantee having or holding actual possession of the deed.

Even if the grantee does not have possession of the deed, the deed is not necessarily considered void as never having been delivered. When a grantee is not physically handed the deed, a *constructive delivery* of the deed may still have taken place.

**Constructive delivery** of a deed to the grantee is deemed to have occurred if:

- the deed is understood by the grantor and the grantee to be delivered by an agreement between them when the grantor signs the deed; or
- the deed is delivered to a third party for the benefit of the grantee, and the grantee or an agent of the grantee demonstrates the grantee's acceptance of the deed, or acceptance may be presumed. [Calif. Civil Code §1059]

For example, a property owner intends to deed property to a family member (the grantee). The owner prepares and signs a deed as the grantor and **delivers it to his agent** with instructions to record the deed on the death of the owner. The agent accepts the deed and, as instructed, does not record it.

The grantee knows the deed exists and lives on the property with the owner under the presumption the grantee now owns the property. After the death of the owner, the deed is recorded and delivered to the grantee by the agent as instructed.

Was the deed constructively delivered to the grantee when it was handed to the agent?

Yes! *Constructive delivery* of the deed occurred when the deed was delivered to the agent since he was acting for the benefit of the grantee and the grantee's acceptance of the deed could be presumed from the grantee's conduct. [**Kelly** v. **Woolsey** (1918) 177 C 325]

## Grantor's intent to convey

Without an owner's present *intent to convey* title as a grantor, a deed will not be considered delivered, even if the grantee is handed the grant deed and accepts physical possession of the deed.

Consider an owner who hands a grantee a deed as a gift. However, the owner orally advises the grantee that the deed is not to be effective until the owner dies, and if the grantee dies first, the deed must be returned to the owner. The owner of the real estate does not intend for the deed to be a present transfer of the ownership of the real estate to the grantee.

The owner dies and the grantee records the deed. Heirs of the owner assert they own the real estate, claiming the deed was not delivered and is invalid since the owner did not intend for the deed to convey ownership at the time the deed was handed to the grantee.

The grantee claims the deed is a valid conveyance of the real estate since delivery took place when the owner personally handed him the deed and he accepted it, subject to the condition of a delayed transfer.

Was the deed a valid conveyance of the real estate?

No! To be a *valid delivery*, both the owner and the grantee must **intend** for title to the real estate to be **conveyed concurrent** with the handing of the deed to the grantee. The owner of the real estate must

intend for the document used to convey the real estate to operate as a deed which **immediately divests** the owner of title.

Since the owner intended the deed to become operative only on his death, as evidenced by the his actions and statements when the deed was handed to the grantee, the deed is considered an improper probate avoidance device, and is void, conveying nothing.

A deed handed to the grantee cannot act as a will or revocable inter vivos (living) trust agreement to transfer property on the death of the owner.

A will and an inter vivos trust agreement are *testamentary documents* which take effect after they are signed, on the owner's death. Upon entering into a will or trust agreement, the owner does not give up control or ownership until his death.

Conversely, a deed is a document used to **immediately pass** fee simple title (or other estate) on recording or the grantee taking possession of the deed. If the grantor does not intend to pass fee simple (or other estate) on handing the deed to the grantee, no actual delivery takes place and the deed is void. [**In re Estate of Pieper** (1964) 224 CA2d 670]

Consider a property owner who conveys real estate to a grantee by a grant deed. The grant deed states the owner **reserves a life estate** for himself. The grant deed is delivered to the grantee, who takes possession of the grant deed but not the real estate, possession being retained by the owner.

In this example, the grantee under the deed reserving a life estate for the grantor is not entitled to possession of the property until the grantor dies. However, the deed is valid and title to the property has been conveyed to the grantee in spite of the deed's reservation of a life estate since the owner intended to immediately convey title, subject to the life estate he reserved for himself. [**White** v. **Hendley** (1921) 185 C 614]

## Grant deed as a mortgage-in-fact

Usually a grant deed is used with the intent to pass full legal title to the described property when it is handed to the grantee or recorded by the grantor.

However, when a grant deed is intended to convey title to a lender as *security* for the repayment of a debt he owes, in spite of its wording of conveyance, the grant deed does not transfer the right of ownership.

A grant deed given to provide a creditor with the property as **security** (collateral) is a *mortgage-in-fact*. Thus, a *lien* is imposed on the property in favor of the lender, similar to a trust deed lien.

For example, an owner wants a loan but has poor credit and can not qualify for an institutional loan. A private lender agrees to lend the owner the needed funds. The private lender receives a grant deed to the property as security in the event of a default on the loan. The real estate is to be *reconveyed* to the owner when the loan is fully repaid.

The owner retains possession of the property and remains responsible for the payment of taxes, a trust deed lien of record, and maintenance of the property. The grant deed to the lender is coupled with a lease and option to repurchase the property on an installment program (rent) with a final/balloon payment (when the option is exercised).

Before the loan is repaid, the owner seeks to sell the property by listing it with a broker.

To investigate the condition of title, the broker's agent orders out a property profile from the title company. It shows the recorded title to the property is vested in the name of the private lender, not the owner. The agent now questions whether his client is the true owner of the property and will be able to convey title if a buyer is located to acquire the property.

However, the owner is the legal owner of the property and the lender simply holds a lien on title, evidenced by the grant deed and all the unrecorded loan and lease-option documents.

In this instance, the owner and the lender entered into a loan arrangement in which the **grant deed was intended** to be used as a *security device* for the lender to hold the property as collateral until the loan is repaid in full, not to convey any right of ownership of the real estate to the lender. [**Orlando v. Berns** (1957) 154 CA2d 753]

Brokers and their agents who arrange loans should always use a trust deed as the device which attaches the debt as a lien on real estate. Using a grant deed as a security device is improper practice. A grant deed is generally equated to the grantor's intent to convey all rights and title in the property to the named grantee.

A trust deed does not convey any ownership rights in the property to the lender. Rather, a trust deed imposes a lien on the property in favor of the lender to secure the owner's performance of a money obligation owed the lender. On executing a trust deed, the owner retains all ownership rights to the secured property, which is the intent when using a trust deed.

## Conditional delivery of deed

A deed cannot be delivered conditionally to the grantee himself with instructions placing conditions on its use, called a *conditional delivery*.

An *absolute conveyance* occurs when a deed is handed to the grantee or received by constructive delivery. Any conditions imposed by the grantor which are not stated in the deed are unenforceable. Once a deed is delivered, it operates free from conditions not written in the deed. [CC §1056]

The **conditional delivery rule** only applies to deeds handed to the grantee. On the contrary, a deed may be conditionally delivered to a *third party*, such as an escrow agent, broker or attorney when the seller is preparing to convey the property under contract. A deed delivered to a **third party** with instructions to hand the deed to the grantee on the occurrence or performance of a condition is valid. [CC §1057]

For example, a seller opens escrow and hands escrow his grant deed with written instructions authorizing escrow to deliver the deed when the buyer has fully performed and escrow is in a position to close.

Escrow delivers the deed to the buyer on the close of escrow. Escrow records the deed with the county recorder who then mails it to the buyer under the return-of-document instructions set forth on the deed.

Once placed in escrow, the grant deed can only be returned to the grantor if the grantee fails to perform as agreed, or by the written instructions of the grantor and grantee to escrow.

## Deed erroneously released to buyer

Consider a seller whose broker locates a buyer who agrees to purchase the seller's real estate. Escrow is opened. The seller signs and delivers instructions to escrow together with his signed grant deed. Escrow is authorized to use the grant deed to transfer ownership of the property to the buyer on the close of escrow.

The escrow instructions state the deed is to be recorded and forwarded to the buyer when the buyer performs as agreed. The instructions further state that the deed is to be returned to the seller if the buyer fails to perform by the date specified in the instructions.

The buyer does not perform as agreed. However, escrow mistakenly records the grant deed. The deed is mailed to the buyer by the county recorder.

Did the buyer receive title to the real estate?

No! Escrow did not follow the seller's instructions regarding recording and delivery of the deed on closing. The escrow's **unauthorized recording** and the buyer's possession of the deed is improper since *delivery was not intended* by either the seller or buyer. Thus, title was not conveyed, the deed is void, and no interest was ever conveyed. [**Hildebrand** v. **Beck** (1925) 196 C 141]

## Irrevocable escrow creates life estate

Consider an owner who hands a deed to his broker or attorney with written instructions to hold the deed until his death. On his death, the deed is to be delivered to the grantee.

Under the instructions, the owner does not retain the right to withdraw or revoke the deed as he would have been able to do had he conveyed the property to an inter vivos (living) trust vesting.

Has the owner delivered an enforceable deed to the third party?

Yes! The owner's act of depositing the deed and instructions for its use with a third party and **relinquishing further control** over the deed constitutes delivery of the deed and concurrently transfers title to the individual named as the grantee. The third party holding the deed becomes the *agent* of the grantee. The owner's interest in the real estate is reduced to a life estate on delivery since the owner intends to retain possession, not ownership, and use of the property until his death. [**Husheon** v. **Kelley** (1912) 162 C 656]

Further, once the owner deposits his deed with the third party and relinquishes all control over the deed, the owner's later destruction of the grant deed, such as ripping it up or the agent's redelivery of the grant deed back to the owner, does not reconvey title. [CC §1058]

Additionally, an owner's instructions to escrow to record a deed when escrow is in a position to close creates a presumption of delivery, even if the owner dies before escrow closes. [**Osterberg** v. **Osterberg** (1945) 68 CA2d 254]

## Acceptance by the grantee

A grantee is *presumed* to have accepted a deed if the grant is beneficial to the grantee.

For example, an owner of real estate deposits in an escrow, or with a broker or other agent of the owner, a deed conveying real estate to the named grantee. The owner's written instructions accompanying the deed state the deed is to be delivered to the grantee on the owner's death. The owner will continue to occupy the property.

The instructions contain no provisions for the owner's withdrawal of the deed from escrow. Thus, the owner retains no power to revoke the deed. However, the grantee is not aware of the existence of the grant conveying title to the real estate.

On the owner's death, escrow delivers the deed to the grantee as instructed.

Is the deed considered valid even though the grantee, being unaware of the deed, did not formally accept it?

Yes! The delivery of the deed to a third party, such as an escrow or someone else acting as the owner's agent, with instructions to deliver the deed to the grantee on the owner's (grantor's) death is considered *constructive acceptance* by the grantee — even though the deed's existence was unknown to the grantee.

The conveyance of the property was for the grantee's benefit and thus the deed was **presumed** to have been accepted by the grantee when the deed was **conditionally delivered** to a third party. [**Windiate** v. **Moore** (1962) 201 CA2d 509]

Additionally, a deed is **presumed to be accepted** and the conveyance complete if the deed is:

- physically handed to the grantee [**California Trust Co.** v. **Hughes** (1952) 111 CA2d 717];
- recorded by the grantee [**Drummond** v. **Drummond** (1940) 39 CA2d 418]; or
- in the grantee's possession. [California Trust Co., *supra*]

### Conditional acceptance by grantee

The conditional acceptance of a deed by a grantee does not constitute delivery. A deed is not effective until the grantee or his agent *unconditionally accepts* the deed. [**Green** v. **Skinner** (1921) 185 C 435]

For example, a secured lender initiates foreclosure proceedings on an owner's property. The owner does not want a foreclosure in his name since it would adversely affect his credit. Thus, the owner offers to deed the property to the lender in exchange for cancellation (satisfaction) of the debt secured by the property, called a *deed-in-lieu of foreclosure*.

However, the lender states the deed will not be accepted until:

- the property is free of any encumbrances junior to his trust deed; and
- the title is insured under a policy issued by an insurance company.

The owner hands the lender the **deed-in-lieu of foreclosure**. However, a title search in anticipation of obtaining title insurance discloses a junior trust deed lien exists on the property. The lender proceeds with the foreclosure and does not record or rely on the deed-in-lieu of foreclosure since the condition of title is unacceptable to the lender.

The junior lienholder discovers the existence of the unrecorded deed-in-lieu of foreclosure and claims the lender cannot foreclose since the lender accepted the deed-in-lieu of foreclosure subject to the junior trust deed (which would then become a first trust deed).

However, the lender agreed to accept the deed only on confirmation that title is clear of junior liens. The grantee's receipt of a deed, with acceptance of the deed **conditioned on confirmation** of the title condition, is not a delivery of the conveyance when received.

A deed is effective when handed to the grantee only if the grantee **unconditionally accepts** the deed. In this example, the lender did not receive the deed with the **intention of accepting delivery** of the deed as an immediate conveyance of title. [**Brereton** v. **Burton** (1938) 27 CA2d 464]

Now consider a borrower who, aware of the lender's conditions for accepting a deed-in-lieu of foreclosure, records the deed with instructions to the recorder to mail the deed to the lender. The borrower's intent is to force the acceptance on the lender since the lender's conditions regarding junior liens cannot be met.

If the lender is unwilling to accept the deed when it is received from the recorder, the lender must act (in a writing or with litigation) to state that the deed is not accepted. The borrower cannot force the lender to accept a deed to property by simply recording it. The conveyance, while clouding the enforceability of the lender's trust deed, is ineffective until the lender's conditions for acceptance are met.

### Consideration given for deed's sake?

A grantor's receipt of consideration is not necessary for a voluntary conveyance of real estate by deed. A deed is not void for **lack of consideration** received by the grantor for conveying property. [CC §1040]

Further, without fraud or misrepresentation on the part of a buyer of real estate, a deed cannot be voided or rescinded by a seller for a buyer's **failure to pay** the balance due on the purchase price. A delivered deed is not void or voidable and the title remains with the buyer when the buyer fails to tender the balance of the purchase price he agreed to pay to the seller after taking title.

The seller, having conveyed the property, can only recover his money losses in a judgment or by foreclosure of a carryback trust deed. [**Lavely** v. **Nonemaker** (1931) 212 C 380]

However, if the buyer promises to pay a portion of the purchase price after taking title and performance of the deferred payment on the price is unsecured, the seller is entitled to a *vendor's lien* on the property sold for the portion of the price that remains unpaid. [See Chapter 38]

Additionally, when a grantor conveys real estate to a grantee for the purpose of avoiding creditors by stripping the grantor/debtor of his assets, the conveyance can be set aside by the creditors as a *fraudulent conveyance*. [CC §§3439 et seq.; see Chapter 38]

A conveyance will be considered **fraudulent** if:

- the grantor intends to defraud creditors by avoiding payment;
- a reasonably equivalent value is not received by the grantor in exchange for the property transferred; and
- the grantor is or will become insolvent on the conveyance, or he intended or should have known he would incur debts beyond his ability to pay. [CC §3439.04]

### Recording the grant deed

To convey real estate, the deed does not need to be recorded. A deed that is delivered conveys an interest in real estate even when the deed is **incapable of being recorded**.

For example, title to an owner's undivided one-half interest in real estate is vested in the owner and a co-owner as joint tenants.

The owner signs and delivers a deed conveying the property to a grantee, an act which severs the joint tenancy with the co-owner. The owner's signature on the deed is not acknowledged by a notary public, which is a requisite to its being recorded. [Calif. Government Code §27287]

The co-owner claims the deed signed by the owner was not delivered since the grantor's signature on the deed was not acknowledged by a notary.

In this instance, delivery of the deed is not affected by the fact that the deed was not acknowledged or recorded. The owner's delivery of the signed deed to the grantee was sufficient to convey the co-owner's interest and sever the joint tenancy. [**Gonzales** v. **Gonzales** (1968) 267 CA2d 428]

A deed only needs to be recorded to put future buyers or encumbrancers on notice of the transfer. Recording the deed *perfects ownership* of the interest conveyed against others who might later claim an ownership, security or leasehold interest in the property.

A deed **capable of being recorded** with the county recorder must include:

- **identification** of the person requesting the recording, and the person to whom the document will be returned by the county recorder as indicated at the top left hand corner of the deed [Gov C §27361.6]; and
- the **address** where and to whom tax statements are to be sent by the county tax collector, indicated at the bottom of the first page. [Gov C §27321.5]

Failure to identify the person requesting the recording of the deed, where the deed is to be sent after recording, or where the local real estate tax statements are to be sent does not affect the validity of the deed or the *constructive notice* to others implied by recording the deed. [Gov C §§27321.5, 27361.6]

The deed submitted for recording must also include the amount of the *documentary transfer tax* to be paid. The deed will not be recorded by the recorder unless the **documentary transfer tax** is paid at the time of the recording. An additional transfer tax may be charged by the city, county or both the city and the county. [Calif. Revenue and Taxation Code §§11901 et seq.]

Once recorded, a deed constitutes a change of ownership which subjects the property to reassessment. Thus, the deed should be accompanied by a **change of ownership statement** which the recorder hands to the county assessor. [Gov C §27280; Rev & T C §480]

If the deed submitted to the county recorder does not include a change of ownership statement, the recorder will record the document and either:

- include a change of ownership form with the return of the recorded deed; or
- provide the assessor with the identification of the recorded document which was not accompanied by the change of ownership statement. [Gov C §27321]

Additionally, a **notary public acknowledging** an individual's signature on a deed affecting the title to real estate, such as a grant deed, quitclaim deed or trust deed, will require the individual to place his thumbprint in the notary's journal. The **thumbprint requirement** does not apply to the recording of a trustee's deed or a reconveyance of a trust deed. [Gov C §8206(a)(2)(G)]

## Void vs. voidable deeds

*Void* and *voidable* are terms which seem similar but are distinguishable by the date they affect the validity of a deed, and thus, the rights of those who relied on the deed.

**Void deeds** are unenforceable and never convey an interest in real estate at any time, a concept called *void ab initio* — without legal effect from the beginning.

If title is claimed under a void deed, any claim of ownership under the deed must fail, even if a further grantee purchases the property in good faith without any notice of a defect in title or in the deed held by the grantor.

For example, an owner of real estate has been adjudicated as insane and unable to manage his affairs (incompetent). The court appoints a guardian to manage the owner's affairs.

A buyer, unaware of the owner's condition or guardianship, purchases real estate from the owner. The buyer obtains a grant deed to the property from the owner.

Is the deed on the sale of the real estate a valid conveyance since the buyer was unaware of the owner's condition and paid a fair value for the property?

No! Prior to the conveyance, a court found the owner to be incompetent and appointed a guardian to manage his affairs. The **appointment of a guardian** by the court is considered notice to all of the owner's condition — whether or not a notice of appointment is recorded — since adjudication of the owner's incompetence is considered notice.

Thus, the buyer's status as a bona fide purchaser (BFP) of title from an adjudicated incompetent does not shield the deed from being set aside. The deed was void at its inception and had no legal effect at any time. [CC §40]

Other examples of **void deeds** include:

- a deed signed and delivered by a seller under the age of 18 — due to legal *incapacity* [Calif. Family Code §6701];
- a deed handed directly to the grantee with the intent it is not to be effective until the owner's death — conditional delivery to the grantee, not to a third party [Estate of Pieper, *supra*];
- a deed materially altered without the grantor's consent [**Tannahill** v. **Greening** (1927) 85 CA 714]; or
- a forged deed. [**Meley** v. **Collins** (1871) 41 C 663]

## Voidable deeds

A **voidable deed**, unlike a void deed, is a deed which is *valid and enforceable* after delivery until it is challenged due to a defect and a court order declares the deed to be invalid.

Examples of **voidable deeds** include:

- a deed obtained through **false representations**, such as a grantee who acquires title at a trustee's sale by advising the owner he has superior knowledge concerning the property's title condition and then misrepresents the condition of title, inducing the owner to allow the property to be sold by foreclosure [**Seeger** v. **Odell** (1941) 18 C2d 409];
- a deed obtained through **undue influence** or threat, such as imprisoning or restraining the owner until he signs a grant deed [**Campbell** v. **Genshlea** (1919) 180 C 213]; or
- a deed from a grantor of **unsound mind**, but not entirely without understanding, made before the grantor's incompetency to convey has been adjudicated. [CC §39]

Unlike void deeds, a voidable deed is enforceable by a bona fide purchaser (BFP) or encumbrancer who relies on the title held by the grantee under a voidable deed which has not yet been challenged as invalid.

For example, a loan secured by real estate is in default. The owner is concerned the property might be sold through foreclosure, negatively affecting his credit. The owner is approached by a foreclosure consultant who, through fraudulent threats and harassment, is able to obtain a grant deed from the owner.

The consultant, as the grantee under the deed, takes possession of the property and refinances it by obtaining a new loan to pay off the old loan. The new lender, unaware the grantee obtained the grant deed by fraud, is secured by a trust deed on the property now vested in the name of the foreclosure consultant.

Later, the original owner sues the foreclosure consultant to set aside the deed as voidable. The owner records a notice of **pendency of action**, referred to as a *lis pendens*. The grant deed is later declared invalid since the foreclosure consultant, as the grantee, used threats and undue influence to fraudulently obtain the deed.

Meanwhile, the new lender whose security interest rests on the voidable deed begins foreclosure under his trust deed.

The owner, having set aside his deed as voidable, claims the lender cannot foreclose since the deed for the ownership on which the lender's trust deed was acquired has been declared invalid.

Can the lender enforce the trust deed created by the grantee under the fraudulent (and voidable) deed which has been declared invalid?

Yes! The deed was voidable, not void, when it was signed and delivered to the grantee who executed the trust deed now in foreclosure. The lender became an encumbrancer before the grantor (prior owner) challenged the validity of the deed to the grantee (foreclosure consultant).

Thus, the lender is considered a **bona fide encumbrancer** for value and without notice of the defect, entitled to enforce the note and trust deed since the trust deed was recorded before the lender had actual or constructive notice (by the **lis pendens**) of the owner's challenge which ultimately declared the grant deed invalid. [**Fallon** v. **Triangle Management** (1985) 169 CA3d 1103]

# Chapter 27 Grant deed vs. quitclaim deed

*This chapter presents the two most common types of deeds used to convey property interests and their characteristics.*

## The deeds of conveyance

Real estate solely owned as separate property by a married individual is sold.

Before issuing a title insurance policy to insure the conveyance of marketable title to the property against any potential community property claim of the seller's spouse, the title insurance company requests that the spouse join in the grant deed by signing it as the spouse of the grantor.

The spouse signs the grant deed for the sole purpose of releasing any community property interest possibly acquired as a result of the marriage — even though the spouse acquired no interest in the real estate, as reflected by the record title.

After closing, the buyer of the property discovers a tenant who holds a lease which was not agreed to in the purchase agreement as a condition to title nor referenced in the grant deed. As a result, the buyer incurs money losses to relocate the tenant. Meanwhile, the seller dies but is survived by the spouse who joined in the conveyance.

The buyer now seeks to collect his tenant relocation expenses from the seller's spouse for breach of the *implied covenant* in the grant deed signed by the spouse. The **implied covenant** warrants the grantor has not *encumbered* title to the property in any manner, such as creating a lease which was not included as a condition of title in the purchase agreement.

The seller's spouse who joined in the conveyance claims a spouse cannot be held liable for the breach of the **covenant against further encumbrances** when the spouse never had an interest in the property to convey, and that the buyer's only remedy is against the deceased seller.

Is the spouse liable for the breach of the implied covenant against further encumbrances since the grant deed was signed by the spouse as a grantor?

Yes! The covenants implied in a grant deed impose a *personal obligation* on each grantor, whether or not the grantor has an interest in the real estate described in the grant deed delivered to the buyer.

Since the spouse voluntarily participated as a grantor in the conveyance and did not enter into the conveyance through mistake or fraud, the spouse as a grantor **breached the implied covenant** against **further encumbrances** by failing to state the property was subject to the lease. [**Evans** v. **Faught** (1965) 231 CA2d 698]

To avoid the exposure to liability imposed by the implied covenants in the grant deed, the spouse should have signed a quitclaim deed to either the seller or the buyer. A **quitclaim deed** does not contain or carry with it the implied covenants of warranty of title and warranty against encumbrances created during the grantor's period of ownership.

## The granting clause

The two types of deeds commonly used to convey a real estate interest are:

- *grant deeds*; and
- *quitclaim deeds*.

To pass a fee simple interest in real estate, only the word "grant" needs to be used in the conveyance. No other precise words of conveyance are necessary in a deed to convey a fee simple ownership. [Calif. Civil Code §1092]

The word "grant" contained in the conveyance provision in a grant deed indicates the conveyance of a fee simple interest to another individual, unless the deed states a lesser interest is conveyed. [See Form 404 accompanying this chapter]

A **quitclaim deed** customarily uses the words "remise," "release" or "quitclaim," but does not contain the word "grant." However, only the word "quitclaim" needs to be used to convey all interest held in the property by the grantor. [See Form 405 accompanying this chapter]

A quitclaim deed conveys only the grantor's interest in a property, if any exists. A quitclaim deed can also be used in lieu of a grant deed to pass fee simple in the described real estate.

The words used to convey property are evidence of the **future role** the individual conveying title undertakes after the deed has been signed and delivered. Thus, to convey real estate with **covenants** relating to the interest conveyed, a grant deed is used. To simply convey any interest in real estate without an assurance the individual holds that interest conveyed, a quitclaim deed is used.

## Grant deed covenants are implied

The covenants, sometimes called *warranties*, implied in a grant deed include:

- the interest conveyed in the real estate has not been *previously conveyed* to another, except as disclosed in the grant deed; and
- the real estate has not been *further encumbered* by the grantor, except as disclosed in the grant deed. [CC §1113]

Grant deed covenants are **implied**. Thus, they are not separately bargained for as provisions to be included in the grant deed conveyance.

**Figure 1** *Excerpt from* **first tuesday** *Form 552 – Nonresidential Lease Agreement*

**19. ASSIGNMENT, SUBLETTING AND ENCUMBRANCE:** [Check only one]

19.1 ☐ Tenant may not assign this lease or sublet any part of the premises, or further encumber the leasehold.

19.2 ☐ Tenant may not transfer any interest in the premises without the prior consent of Landlord.

a. ☐ Consent may not be unreasonably withheld.

b. ☐ Consent is subject to the attached conditions. [**ft** Form 250]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

*SPACE ABOVE THIS LINE FOR RECORDER'S USE*

MAIL TAX STATEMENTS TO:

Name

Street Address

City & State

DOCUMENTARY TRANSFER TAX $______________

☐ Computed on the consideration or value of property conveyed; or

☐ Computed on the consideration or value less liens or encumbrances remaining at time of sale.

☐ Unincorporated area: ________________________

☐ City of ____________________________________,

______________________________________________
*Signature of Agent determining tax*

# GRANT DEED

I/We, ______________________________________________________________

grant to ____________________________________________________________

the real property in the City of ______________________________________,

County of ______________________________________, State of California, described as:

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

APN # ______________________________

Date:______________, 20______ ______________________________
(Print Name) (Signature)

Date:______________, 20______ ______________________________
(Print Name) (Signature)

STATE OF CALIFORNIA )
COUNTY OF______________________________)
On ______________________________ before me,
______________________________________________
*(name of notary public)*
personally appeared ______________________________
______________________________________________,
*(name of principal)*
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature: ______________________________
*(Signature of notary public)*

*(This area for official notarial seal)*

TAX STATEMENTS TO BE MAILED AS DIRECTED ABOVE

If a grant deed covenant is breached by a seller (grantor), the buyer (grantee) may recover his money losses from the seller for the breach of the implied covenant, as though the covenant had been written into the grant deed. [CC §1113]

## The covenant against prior conveyances

Consider a seller who owns a parcel of real estate with *appurtenant water rights* in other real estate. The seller enters into a purchase agreement with a buyer, agreeing to convey the real estate to the buyer.

The seller signs a grant deed and hands it to escrow to convey the real estate to the buyer on closing. However, before the grant deed is delivered to the buyer, the seller conveys the appurtenant water rights to another individual.

After closing, the buyer learns of the seller's conveyance of the water rights and seeks damages for the seller's breach of the implied covenant against previous conveyances in the grant deed.

In this example, the seller is liable to the buyer for the value of the water rights conveyed to another. The water rights were appurtenant to the property sold. The seller breached the implied covenant in the grant deed by conveying the water rights without noting the conveyance as an *exception in the grant deed* he delivered to the buyer. [**Lyles** v. **Perrin** (1901) 134 C 417]

The covenant against other conveyances by the seller does not also imply the grantor has title to the property, called the *covenant of seisin*. A grantor who conveys property he does not hold title to is not liable for breach of the implied covenant against prior conveyance, or any other implied covenant.

The covenant against prior conveyances only represents that the grantor has not previously conveyed any interest in the property.

Instead, the grantor may be liable to the grantee for money losses caused by his misrepresentation of title, failure of consideration or breach of his promise in the purchase agreement to convey real estate. Further, the grantee may *rescind* the transaction and obtain a return of his funds, called *restoration*. [CC §1689]

The **covenant of seisin** — that the grantor holds title to the real estate being conveyed — is now entirely unused. This covenant has been completely replaced by title insurance.

## The covenant against encumbrances

Real estate **encumbrances** include taxes, assessments, conditions, covenants and restrictions (CC&Rs) and all liens, voluntary or involuntary, attached to the real estate. [CC §§1113, 1114]

Encumbrances are the subject of the implied warranty against encumbrances in the grant deed, since they burden title and depreciate its value. **Encumbrances** include:

- CC&Rs, such as covenants and use restrictions running with the land;
- building restrictions;
- a reservation of a right of way;
- an easement;
- an encroachment;
- a lease; and
- a pendency of a condemnation action. [Evans, *supra*]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

*SPACE ABOVE THIS LINE FOR RECORDER'S USE*

MAIL TAX STATEMENTS TO:

Name

Street Address

City & State

DOCUMENTARY TRANSFER TAX $_______________

☐ Computed on the consideration or value of property conveyed; or

☐ Computed on the consideration or value less liens or encumbrances remaining at time of sale.

☐ Unincorporated area:

☐ City of ___________________________________, and

_______________________________________________

Signature of Agent determining tax

# QUITCLAIM DEED

I/We, ______________________________________________________________________

quitclaim to ______________________________________________________________________

the real property in the City of ______________________________________________________,

County of ____________________________________________, State of California, described as:

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

______________________________________________________________________

Date:______________, 20______ _______________________________________________

(Print Name) (Signature)

Date:______________, 20______ _______________________________________________

(Print Name) (Signature)

STATE OF CALIFORNIA )

COUNTY OF_____________________________________________)

On _____________________________________________ before me,

_______________________________________________________

*(name of notary public)*

personally appeared ______________________________________

_______________________________________________________,

*(name of principal)*

personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature: _____________________________________________

*(Signature of notary public)*

*(This area for official notarial seal)*

TAX STATEMENTS TO BE MAILED AS DIRECTED ABOVE

Consider a buyer who is aware of an existing lease on the property which the seller entered into as the landlord. The lease is not referenced in the purchase agreement or the escrow instructions as a condition of the title to be conveyed to the buyer. The buyer never agrees in writing to take title subject to the existing lease.

Further, the grant deed to the buyer does not state he is receiving title to the legally described real estate *subject to* the existing lease created by the seller.

The transaction closes and the tenant refuses to vacate the property based on agreements entered into between the tenant and the seller. The buyer then incurs expenses relocating the tenant. The buyer makes a demand on the seller to reimburse him for the tenant relocation expenses. The buyer claims the seller breached the implied covenant against encumbrances in the grant deed delivered to the buyer.

The seller claims the buyer cannot recover his expenses for the tenant's relocation since the buyer had constructive knowledge (the tenant was in possession) and actual knowledge the lease existed at the time he accepted delivery of the seller's grant deed.

In this example, the **buyer's knowledge** that the lease existed does not bar recovery of his costs to relocate the tenant based on the seller's breach of the implied covenant against further encumbrances. The buyer is entitled to **rely on the grant deed** (and the purchase agreement). Thus, the seller was obligated under the implied covenant in his grant deed to deliver title clear of the lease he created. [Evans, *supra*]

## Improvements are real estate, not encumbrances

**Physical changes** in a property, generally resulting from *improvements*, are not considered encumbrances even through they affect the property's value. Since improvements are readily seen on the property, their existence places the buyer on notice.

For example, a water district constructs a large levee across an owner's property after the owner grants the district an easement. The water district owns and is in possession of the levee which is within the easement.

The owner conveys the real estate to a buyer with a grant deed. The grant deed does not reference the water district's easement created during the grantor's ownership. The buyer believes he purchased the property free and clear of any encumbrances and is unaware the water district has an easement over the property or owns the levee.

Due to the interference of the water district's levee, the buyer is unable to use the property as planned and is prevented from using the property located within the easement.

The buyer seeks damages from the seller for breach of the implied covenant against encumbrances.

However, *encumbrances* do not include visible physical or permanent burdens on real estate. Improvements affecting the physical condition of a property and its value are open and notorious. A buyer accepts the property subject to the **physical improvements** since he is charged with notice of them as part of the real estate purchased.

**Physical improvements** are not considered an encumbrance since the improvements only affect the physical condition of the property, not its title like an easement. [Evans, *supra*]

In another example, a seller fails to disclose to a buyer that the soil used for a fill on the property is not compacted. The buyer builds a single family residence on the property and his residence sinks due to the uncompacted soil.

The buyer seeks to recover his money losses from the seller for the damage to his residence caused by the poor soil condition. The buyer claims the seller breached his covenants in the grant deed since the seller failed to disclose he altered the property by adding uncompacted soil.

However, a grant deed (or purchase agreement) includes no implied covenant regarding the **physical condition** of a property. Implied covenants only apply to the **condition of title** conveyed by the seller. Thus, the buyer should have based his recovery claim on the seller's misrepresentation of the physical condition of the property improvements — the fill.

A seller's misrepresentations or omissions about the physical conditions existing on the real estate are separate from a breach of title covenants; misrepresentations being a fraud, failure of a grant deed covenant being a breach of contract. [**Gustafson** v. **Dunham, Inc.** (1962) 204 CA2d 10]

If the grantee seeks to make the condition of the property a **contract warranty** and not just a representation, the grant deed or purchase agreement must state the seller is providing a warranty that the property's condition contains no known or unknown defects.

For example, only a representation exists, not a warranty against all known and unknown defects, when the seller discloses the property's physical condition in the Condition of Property Statement (TDS) delivered to the buyer of a one-to-four unit residential property. [See **first tuesday** Form 304]

## Covenants restricted or limited

To avoid liability arising out of the implied covenants in a grant deed, the deed should state the title conditions (encumbrances) created by the seller during his ownership when these conditions are agreed to by the buyer in the purchase agreement.

The implied covenants in a grant deed are *waived* by the buyer and do not apply when the seller (grantor) and the buyer (grantee) agree to the contrary in the purchase agreement and list the title changes made by the seller in the grant deed — as long as all changes made by the seller are listed.

For example, if the grantee is taking title subject to encumbrances placed on the property by the seller, the grant deed should state the property is "subject to" encumbrances of record, and list each of these encumbrances.

The implied covenants in the grant deed only insure the property has not been previously conveyed or encumbered by the grantor. No other promises regarding the title or condition of the property are implied in the grant deed.

## Covenants personal to grantor/grantee

Implied covenants are only for the **personal benefit** of a buyer, not future owners, called *remote grantees*. The implied covenants in a seller's grant deed to a buyer do not impose a condition on title and do not *run with the land*.

Thus, being personal to the seller (grantor) and the buyer (grantee), the implied covenants in a grant deed can only be enforced by the buyer (grantee) named in the deed. Implied covenants cannot be enforced by **remote grantees** who acquire the buyer's interest at a later date.

Conversely, covenants **running with the land**, such as conditions, covenants and restrictions (CC&Rs) or easements, bind all future owners (remote grantees) of the property, whether they take title by deed or court order. Covenants running with the land affect title.

For a **covenant to run with the land** and affect all remote grantees, the seller creating the covenant must state in his conveyance that *successors* (remote grantees) are bound by the covenants and restrictions imposed on the property as contained in the deed. [CC §1468]

Consider an owner who encumbers his real estate with a first trust deed lien. The owner then sells the property to a buyer who agrees in the purchase agreement and escrow instructions to take title subject to the first trust deed.

Title is conveyed by grant deed to the buyer. However, the grant deed does not note the title is subject to the first trust deed created by the owner.

Later, the property is resold by the buyer. The purchase agreement and the escrow instructions for the resale disclose the existence of the first trust deed — specifically, the remaining balance on the first trust deed note to be assumed as part of the terms for payment of the purchase price on the resale to the new buyer.

The grant deed for the resale states the new buyer will take title subject to all encumbrances of record.

Later, on a search of the record title, the new buyer discovers the first trust deed lien he took over was not referenced in the grant deed conveyance to his seller from the prior owner of the property who created the trust deed lien.

The new buyer seeks to recover money from the prior owner for the amount of the debt secured by the trust deed based on the prior owner's breach of the implied covenant against encumbrances. The new buyer claims he has suffered losses since the trust deed created by the prior owner was not referenced in the prior owner's grant deed when he sold the property.

Is the new buyer entitled to recover money losses from the prior owner for the breach of the implied covenant against encumbrances contained in the grant deed?

No! The covenant implying the real estate is free from further encumbrances created by the prior owner is a **personal covenant**, held by and for the benefit of the original buyer only. An implied covenant does not run with the land for the benefit of a subsequent buyer. Thus, the new buyer cannot recover money losses for the breach of an implied covenant under a grant deed which did not name him as the grantee.

Further, the new buyer agreed to the first trust deed since it was referenced in his purchase agreement and escrow instructions. Usually, a buyer's knowledge of an encumbrance does not bar an action by the buyer against the seller for the breach of implied covenants.

In this instance, the new buyer is not entitled to be *unjustly enriched* for the prior owner's breach of the covenant against encumbrances when the new buyer agrees in the purchase agreement to take title subject to the encumbrance. [**Babb** v.**Weemer** (1964) 225 CA2d 546]

### Title insurer's right to pursue the seller

Title insurance companies issue policies of title insurance covering the conveyance of real estate interests based on the condition of title.

Occasionally, a title company fails to properly search or accurately document the record title of real estate, and issues a policy which fails to reference the seller's activity which affected title, such as a lien or conveyance entered into by the seller.

A policy of title insurance insures the buyer (grantee) against changes in the recorded title made by the seller (grantor) when the changes are not excluded from coverage by the terms of the purchase agreement.

For example, a seller of real estate encumbers his property with a trust deed during his ownership. To sell the property, a purchase agreement is entered into calling for the buyer to take title clear of all encumbrances except those listed. The trust deed encumbrance is not mentioned in the purchase agreement. Also, the seller's grant deed to the buyer does not state the title is subject to the encumbrance.

Further, the title insurance company insuring the grant deed fails to discover and disclose the encumbrance as an exception to coverage. Thus, the title insurance company indemnifies the buyer against the existence of the trust deed encumbrance on the property.

The buyer claims both the title insurance company and the seller are liable under their agreements with the buyer; the title insurance company under its policy, the seller under the implied covenant against further encumbrances in the grant deed.

If the title insurer pays this claim, the insurer will be *subrogated* by the terms of the policy to the buyer's claim against the seller and the seller's liability will shift to the title company.

Consider a property owner who grants a neighbor a view easement which imposes limits on the height of improvements on the owner's property. The neighbor records the document conveying the easement, called an *easement deed*.

The owner then sells the real estate, which is now subject to the view easement he created. Neither the purchase agreement nor the escrow instructions disclose the existence of the easement created by the owner.

Before closing, the owner **orally informs** his buyer of the view easement.

The owner further informs the buyer and the company providing title insurance he does not know whether the easement deed is recorded. A preliminary title report issued by the title company does not disclose the existence of the recorded easement deed. Neither the purchase agreement nor the escrow instructions are altered to reflect the existence of the easement.

Further, the owner's grant deed conveys the property to the buyer and makes no reference that the legally described real estate is subject to the easement created by the owner.

The title insurance policy issued to the buyer does not list the view easement as an exception to the insured condition of title.

After closing, the buyer discovers the easement was recorded while the owner held title. The buyer makes a claim against the title insurance company for the amount of the decrease in the value of the property caused by the easement.

The title insurance company pays the buyer's claim since title was insured against the recorded existence of the view easement. In exchange, the **buyer assigns** to the title company any rights held by the buyer against the owner for breach of the implied covenants in the owner's grant deed.

## Recovery by subrogation to buyer's loss

The title insurance company then seeks to recover its payment of the claim from the owner based on his breach of the implied covenant to the buyer under the grant deed.

The owner claims the title insurance company cannot enforce a claim held by the buyer and assigned to the title company regarding the buyer's rights against the owner under the grant deed, called *subrogation*, since the buyer and the title insurance company were both aware of the easement before closing.

Is the title insurance company entitled to be **subrogated** to the rights of the buyer under the grant deed and recover the amount it paid for the buyer's lost value caused by the easement?

Yes! The buyer's and title insurance company's knowledge of the easement does not prevent recovery from the owner. The buyer is entitled to rely on the implied covenant against further encumbrances, which automatically accompanies the grant deed, unless the covenant is:

- *restricted* by listing the easement in the grant deed; or
- *waived* by agreeing to take title subject to the encumbrances in the purchase agreement, escrow instructions or other writing.

Further, the owner would be **unjustly enriched** if he were allowed to keep the entire amount of the purchase price received from the buyer since the price paid by the buyer did not reflect the reduced value caused by the easement.

Thus, the title insurance company, by the assignment, is entitled to step into the shoes of the buyer for the claim against the owner (by subrogation/equitable assignment) on payment to the buyer of the buyer's claim against the owner under the title insurance policy. The title insurer then pursues enforcement of the buyer's claim under the grant deed covenant against encumbrances. [**Fidelity National Title Insurance Company** v. **Miller** (1989) 215 CA3d 1163]

*Editor's note — An erroneous **preliminary title report** cannot be relied on as a warranty by the title insurance company of the condition of recorded title. A preliminary title report is merely an offer to issue a policy on the same terms and conditions, unless amended before closing. However, a seller is entitled to offset the title insurance company's recovery of its losses if the seller can show he justifiably relied on the title insurance company's representation concerning the non-existence of a recorded easement.*

*For the seller to justifiably rely on the title company, the title insurance company must issue an **abstract of title** policy to the seller. If an abstract of title policy discloses no easement of record when one exists, the title company is liable to the seller for the negligent preparation of the abstract of title, unless the seller knew the easement existed. [**Barthels** v. **Santa Barbara Title Company** (1994) 28 CA4th 674]*

## Purchase agreement merges into deed

Title conditions bargained for and agreed to in the buyer's purchase agreement are *merged* into the grant deed accepted by the buyer on closing. [See **first tuesday** Form 150 §11.3]

Thus, when a title condition, such as a reservation of an easement by a seller, is agreed to in the purchase agreement, it must be restated in the grant deed if the condition is to become enforceable by the seller. The title condition agreed to in the purchase agreement is extinguished on closing by the **merger** of the bargained for title condition into the grant deed.

The *grant deed*, by merger, becomes the sole remaining **basis for enforcement** of either the buyer's or seller's rights to title. Thus, after closing, a purchase agreement provision affecting title is only enforceable if it is implied or stated in the grant deed. Recovery under the title insurance policy is an entirely separate source of recovery.

However, if a title condition, covenant or restriction (CC&R) is agreed to in the purchase agreement, but is **erroneously omitted** when escrow prepares the grant deed, the grant deed can be ordered corrected (by a court) to include the covenant, a legal process called *reformation*. Once the grant deed is corrected to include the omitted title condition, the condition is then enforceable since it is present in the grant deed. [CC §3399]

## Grant deeds and after-acquired title

Consider an individual (grantor) who conveys title by grant deed to real estate he purports to own, but does not actually own in part or at all. Should the grantor later acquire title to the real estate interest he previously conveyed by grant deed, the *after-acquired title* to the real estate legally passes to the grantee under the grant deed. [CC §1106]

For example, an owner decides to sell property which is subject to an oil and gas lease calling for royalties (rent) to be paid to the owner by the tenant. The owner conveys his oil and gas rights by grant deed and transfers the oil and gas lease by assignment to an investor. Thus, the owner no longer owns the oil and gas rights in the real estate and no longer is entitled to receive royalties (rents) from the tenant under the lease.

Later, the owner locates a buyer of his remaining fee interest in the real estate. Neither the purchase agreement with the buyer nor the escrow instructions disclose the owner's prior conveyance of the oil and gas rights or the lease he entered into regarding those rights.

When a preliminary title report discloses the existence of the oil and gas lease, but not the recorded grant deed conveying the oil and gas rights or the lease assignment, the transaction is renegotiated and escrow instructions are amended by the owner's broker to provide for the owner to assign the oil and gas lease to the buyer. Further, the grant deed to the buyer does not limit the implied covenant against prior conveyance by referencing the prior transfer of the oil and gas rights held by the owner.

Later, after escrow closes, the owner reacquires the oil and gas rights by deed and the oil and gas lease by assignment.

However, on conveyance and assignment of the oil and gas rights back to the owner, these later acquired rights automatically pass *by operation of law* under the prior grant deed from the owner to the buyer who bought the real estate. The owner had previously conveyed the entire fee simple to the buyer, which included the oil and gas rights, subject only to the tenant's rights which still exist under the oil and gas lease. [**Schwenn** v. **Kaye** (1984) 155 CA3d 949]

## Conveying lesser estates than the fee

If a buyer of real estate is receiving an ownership interest which is less than fee simple, the grant deed must explicitly state the lesser interest being conveyed to the buyer.

For example, to convey a **life estate**, the grant deed would state the grantee is to hold the property until the grantee's (or some other individual's) death, at which point the title will revert back to the grantor or the grantor's successors.

## Covenants in a trustee's sale

The implied covenants of a grant deed apply to all *nonjudicial sales* of property which transfer a fee simple interest by grant deed. Conversely, transfers of real estate by *judicial order*, as well as by quitclaim deeds, carry no covenants (warranties) at all.

For example, a sale in a probate proceeding and the conveyance of real estate by a grant deed signed and delivered by an executor is a private, **nonjudicial sale**, not a **judicial sale**. The conveyance transferring title is not directed by an order of the court, though the court may have approved the sale. As a nonjudicial sale, the implied warranties of title in the executor's grant deed apply, unless the grant deed states otherwise. [**Mains** v. **City Title Ins. Co.** (1949) 34 C2d 580]

Now consider a trustee's foreclosure sale under a trust deed. The trustee acts on the authority given by the property owner (trustor) to sell and convey title to the real estate at a trustee's sale under the power-of-sale provision in the trust deed should the lender (beneficiary) declare a default and elect to foreclose.

Since the trustee's foreclosure process is a nonjudicial procedure, the implied covenants exist in the trustee's deed issued by the trustee on a foreclosure sale, unless the Notice of Trustee's Sale (NOTS) and the trustee's deed provisions eliminate the covenants. Standard NOTS and trustee's deeds avoid the implied covenants by stating the trustee transfers title with *no warranty.* [See **first tuesday** Form 474 and Form 475]

Additionally, a trustee's deed passes title to the real estate sold at the trustee's sale in the same condition as the title existed on the date the trust deed was recorded, called the *relation back theory*.

A trustee's deed conveys title to a buyer subject to all senior rights and encumbrances of record. The title received by the buyer at the trustee's sale is free and clear of any interest claimed by the prior owner or successors to the owner, and any liens, encumbrances or interests in the property junior in time of recording or subordinated to the trust deed which was foreclosed. [**Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605]

## Quitclaim deeds: you have what I had

A *quitclaim deed* terminates any interest in the real estate described in the deed which may be held by the person (grantor) signing and delivering the quitclaim deed.

Unlike a grant deed, a **quitclaim deed** does not carry with it the implied covenants contained in a grant deed. A quitclaim deed operates to **release to the grantee all interest** the grantor may hold in the property. [**Platner** v. **Vincent** (1924) 194 C 436]

A quitclaim deed passes whatever title, legal or equitable, the grantor possessed on execution (signing and delivering) of the quitclaim deed.

While a quitclaim deed is not intended to assure the conveyance transfers full fee simple ownership, the individual who **holds fee title** and signs and delivers a quitclaim deed does convey fee simple ownership of the property, and all the benefits of holding fee simple title. [**Spaulding** v. **Bradley** (1889) 79 C 449]

## After-acquired title and quitclaims

Unlike a grant deed, a quitclaim deed does not also pass the grantor's after-acquired title to the real estate described in the quitclaim deed. The quitclaim deed is a *release* of the grantor's interest in the real estate at the time it is signed and delivered.

The individual signing and delivering a quitclaim deed does not promise to convey an interest in the real estate, much less agree he has received it (seisin) and not previously conveyed or encumbered it (implied covenants).

However, after-acquired title will pass to a buyer named in a previous quitclaim deed if:

- the seller sold by use of a quitclaim deed an *unperfected right* in the property which will later ripen into ownership, called an *inchoate right*, such as the interest held by a beneficiary under a will or inter vivos (living) trust prior to the death of the property owner [**Soares** v. **Steidtmann** (1955) 130 CA2d 401]; or
- the seller is *estopped* (barred) by his sales agreement or his conduct from claiming the after-acquired title does not pass to the buyer.

The seller is **estopped** from claiming the after-acquired title does not pass if:

- the quitclaim deed contains recitals or covenants, such as an *assignment clause*, showing the seller's intention was not to limit the interest conveyed to only the interest the seller had at the time the quitclaim deed was executed; or
- the seller has affirmed, or his conduct has implied, he actually had an interest in the property which was to be conveyed. [**In re Wilson's Estate** (1940) 40 CA2d 229]

## Judicial sales and sheriff's deed

Deeds executed by agents of the court, such as a receiver or sheriff, to transfer title under a judicial foreclosure sale, an execution sale or other court-ordered sale are similar to quitclaim deeds in that none of these carry with them the *implied covenants* of a grant deed. Only an owner's interest in a property, if any exists, which was subject to the judicially ordered sale is conveyed. Likewise, any after-acquired title later acquired by the owner in the property sold by judicial order does not later pass to the buyer.

A sale is considered judicial if the property is conveyed by an order of the court to carry out a judgment, such as a sale on the execution of a money judgment or a judicial foreclosure sale. [**In re Backesto's Estate** (1923) 63 CA 265]

Additionally, a buyer and broker at a judicial foreclosure sale have the responsibility to investigate and determine the condition of the property, and the ownership interest and condition of the owner's title being conveyed by order of the court, since *no warranties exist*. [Mains, *supra*]

# Chapter 28 — Preliminary title reports

*This chapter examines the use of a preliminary title report by a buyer to review the condition of title before allowing contingency provisions in purchase agreements to expire, and by escrow to prepare closing documents.*

## An offer to issue title insurance

An investor enters into an agreement to purchase real estate from a financially distressed seller.

Closing of the transaction is contingent on the investor's receipt and review of a preliminary title report (prelim) to confirm the property is subject only to the loans and other liens disclosed by the seller. Any taxes or monetary liens of record which are not disclosed in the purchase agreement are to remain of record. However, the amount of any undisclosed lien will be deducted from the cash down payment.

Escrow is opened with instructions to order a prelim from a title insurance company for approval of the condition of title by the investor. To keep acquisition costs to a minimum, escrow is instructed to close without obtaining a policy of title insurance.

The prelim received by escrow indicates the title is clear of all encumbrances, except those disclosed by the seller. Believing the title condition is as represented by the seller, the investor waives the further-approval contingency regarding approval of the prelim. Escrow closes on receiving a "date-down" on the prelim from the title company — without the issuance of a policy of title insurance.

However, the preliminary title report **failed to disclose** a recorded abstract of judgment against the seller which had attached to his title as a judgment lien. Later, the judgment creditor enforces the judgment lien by commencing a foreclosure on the property.

The investor clears title of the lien and makes a demand on the title company for the amount of the payoff since they prepared an **erroneous prelim**. The investor claims the title company is liable for his losses since it failed to disclose the judgment lien on the preliminary title report, a misrepresentation of title.

Can a buyer, escrow officer, broker or agent rely on a prelim as assurance the title condition is "as represented" in the preliminary title report?

No! A preliminary title report is not a representation of the condition of title or a policy of title insurance. Unlike an *abstract of title*, a prelim cannot be relied on by anyone. A title insurer has no duty to accurately report title defects and encumbrances on the preliminary title report (shown as exceptions in the proposed policy). [**Siegel** v. **Fidelity National Title Insurance Company** (1996) 46 CA4th 1181]

A preliminary title report is no more than an **offer to issue** a title insurance policy based on the contents of the prelim and any modifications made by the title company before the policy is issued. [Calif. Insurance Code §12340.11]

## The limited use of the prelim

A preliminary title report typically discloses the current vesting, as well as the general and special taxes, assessments and bonds, covenants, conditions and restrictions (CC&Rs), easements, rights of way, en-

cumbrances, liens and any interests of others which may be reflected on the public record as affecting title, collectively called *encumbrances*.

The closing of many purchase escrows is conditioned on the buyer's approval of the prelim. The buyer, his agent and escrow review the report on its receipt for defects and encumbrances on title inconsistent with the terms for the seller's delivery of title in the purchase agreement and escrow instructions.

Buyer's agents in a sales transaction check the prelim prior to closing for title conditions. Buyers' agents are looking for title conditions which might interfere with any **intended use or change in the use** of the property contemplated by the buyer. Interferences could be in the form of unusual easements or use restrictions which obstruct the buyer's announced plans to make improvements.

Finally, escrow relies on the preliminary report to carry out its instructions to record grant deeds, trust deeds, leaseholds or options which will be insured.

Typically, escrow instructions call for closing when the deed can be recorded and insured, subject only to taxes, CC&Rs and other encumbrances specified in the instructions.

Ultimately, it is the escrow officer who, on review of the prelim, must advise the seller of any need to eliminate defects or encumbrances on title which interfere with closing as instructed.

The prelim and a last-minute *date-down* of title conditions are used by escrow to reveal any title problems to be eliminated before closing and, as instructed, obtain title insurance for the documents being recorded (deeds, trust deeds, etc.).

Should the date-down of the prelim reveal defects or liens not previously reported in the prelim, either by error or by later recording, the title company can **withdraw its offer** under the prelim and issue a new prelim — a different offer to issue a policy on different terms.

### The prelim vs. an abstract of title

Title companies have long been aware of the public's reliance on the prelim. This reliance was consistently reinforced by the California courts which held title companies liable for their erroneous reports. However, legislation drafted by the title insurance industry was introduced and enacted in 1981 to eliminate liability for their preparation of faulty preliminary title reports.

Prelims were once compared to abstracts of title. An **abstract of title** is a written statement which may be relied on by those who order them as an accurate, factual representation of title to the property being acquired, encumbered or leased. [Ins C §12340.10]

An abstract of title is a **statement of facts** collected from the public records. An abstract is not an insurance policy with a dollar limit on liability set by the policy. Since the content of an abstract is intended by the insurance company to be relied upon **as fact**, the insurer is liable for all money losses of the policy holder flowing from a failure to properly prepare the abstract. [**1119 Delaware** v. **Continental Land Title Company** (1993) 16 CA4th 992]

In an effort to shield title companies from an *abstractor's liability* on the issuance of a defectively prepared prelim, the prelim has been legislatively redefined as being neither an abstract of title nor a representation of the condition of title. The prelim is now defined as a report furnished in connection with **an application** for title insurance. [Ins C §12340.11]

The prelim has become and is simply an offer by a title company to issue title insurance. The prelim is merely a statement of terms and conditions on which the title company is willing to issue a policy — subject to last minute changes prior to issuing the policy of title insurance.

# Chapter 29 Title insurance

*This chapter reviews title insurance and presents the distinguishing features of the different types of policies available.*

## Identifying an actual loss

A policy of title insurance is the means by which a title insurance company *indemnifies* — reimburses or holds harmless — a person who acquires an interest in real estate against a monetary loss caused by an **encumbrance on title** that:

- is not listed in the policy, which if listed is called an *exception*; and
- the insured was unaware of when the policy was issued. [Calif. Insurance Code §12340.1]

A policy of title insurance is issued on one of several prototypical forms which are used by the entire title insurance industry in California. The policies are typically issued to **buyers** of real estate, **tenants** acquiring long-term leases and **lenders** whose loans are secured by real estate.

As an **indemnity agreement**, a title insurance policy is a contract. The terms of coverage in the policy set forth the extent of the title insurance company's obligation, if any, to indemnify the named insured for a *money loss* caused by an **encumbrance on title** which is not listed in the policy's *exceptions*. [Ins C §12340.2]

For example, a lender acquires a note secured by a trust deed on real estate. The encumbrances listed as **exceptions** in the lender's policy of title insurance do not include a tax lien which encumbers the property and has priority over the lender's trust deed lien. The lender later discovers the existence of the tax lien.

The lender satisfies the tax lien, forecloses and obtains title by a **full credit bid**. The amount bid includes advances for the tax lien. The lender sells the property at a price in excess of the credit bid and resale costs. The lender makes a demand on the title company under its title insurance policy for the amount of the tax lien claiming the lien reduced the lender's profits on the sale. The title company denies the claim.

In this example, the insured lender cannot recover the **reduction in profits** due to an unlisted defect in title since lost profits are not covered by title insurance. The title insurance policy only indemnifies the insured against a **reduction in the value** of the property below the policy limits, not a reduction in future profits on either a foreclosure or resale of the property. [**Karl** v. **Commonwealth Land Title Insurance Company** (1993) 20 CA4th 972]

## Encumbrances, unknown, undisclosed

Almost all losses due to the reduction in the value of real estate below the policy limits arise out of an *encumbrance*. An **encumbrance** is any condition which affects the ownership interest of the insured, whether the interest insured is a fee, leasehold, life estate or the security interest of a lender.

The word "encumbrance" is all encompassing. Any right or interest in real estate held by someone other than the owner which diminishes the value of the real estate is considered an encumbrance.

**Encumbrances** on title include:

- covenants restricting use;
- restrictions on use;
- reservations of a right of way;
- easements;
- encroachments;
- trust deeds or other security devices;
- pendency of condemnation; and
- leases. [**Evans** v. **Faught** (1965) 231 CA2d 698]

## Property improvement and use not covered

**Physical conditions** on the property itself are not encumbrances which affect title since they are uses which exist and are visible (open and notorious) on the property, such as:

- canals;
- highways;
- irrigation ditches; and
- levees.

Accordingly, title insurance policies do not insure against open and notorious physical conditions which exist on the property, since these observable physical conditions are not encumbrances. A buyer is always presumed to have contracted to acquire property subject to physical conditions on the property which impede its use or impair its value. In the case of encumbrances, recorded or not, no such presumption exists.

A buyer under a purchase agreement contracts to acquire title from a seller free of all encumbrances except those agreed to in the purchase agreement. Even if the buyer has notice of an encumbrance affecting title and he has not agreed in the purchase agreement to take title subject to the encumbrance, the seller is liable to the buyer for its removal, extinguishment or compensation.

However, for title insurance purposes only, the buyer's knowledge of an encumbrance affecting title at the time of closing **removes the known encumbrance** from coverage. Thus, the insured buyer assumes the risk of loss due to the known encumbrance.

## Underwriting only indemnifies a loss

A title insurance policy is not an *abstract of title*. Thus, a policy of title insurance does not *warrant* or *guarantee* the nonexistence of title encumbrances, as does an **abstract of title**. Instead, the insured is *indemnified* up to the **policy's dollar limits** against a money loss caused by a title condition (encumbrance) not listed as an exception or exclusion in the policy.

Under a title insurance policy, the title company only assumes (covers) the risks of a **monetary loss** caused by an encumbrance which is not listed as an exception to coverage, and was unknown to the insured buyer or lender at the time of closing. The title company has no obligation to clear title of the encumbrance.

Consider an owner who discovers the size of an easement was understated in the title insurance policy. Due to the actual dimensions of the easement, the owner cannot develop the property as planned.

The owner makes a claim on the title company for the **lost value** of the property based on its potential for development as allowed by the understated easement, not for his loss of value on the price he paid for the property (which is the dollar amount of the title policy limits).

Instead, the title insurance company only pays the owner an *inflation adjusted price* based on the price the owner paid for the property, an amount set by the policy limits and the inflation endorsement.

The owner claims the title company's *negligence* in the disclosure of the easement caused a loss in property value equal to the difference between the purchase price paid and the potential value of the property for development.

However, the title company is not liable under a policy for **lost profits** in the unrealized potential value of the property. It was the easement that caused the loss of profits, not the issuance of a title insurance policy. [**Barthels** v. **Santa Barbara Title Company** (1994) 28 CA4th 674]

A title insurance company issuing a preliminary title report or a policy of title insurance has two underwriting options when its title search reveals an encumbrance affecting title:

- list the encumbrance in a preliminary title report, requiring the parties to the transaction to either eliminate it or accept it as an *exception* to coverage in the policy of title insurance to be issued; or
- insure against the encumbrance by *writing over* the encumbrance — i.e., not listing it as an exception — and assuming any risk of loss connected to it.

When title companies **write over** a known encumbrance, they usually demand an indemnity agreement from the person responsible for eliminating the encumbrance — typically a money lien, such as a mechanic's lien, money judgment or blanket encumbrance. Thus, the title company can recover if a claim by the insured is later paid due to the encumbrance.

Additionally, a title policy is not a representation of the nonexistence of encumbrances that are not excluded or listed in the policy. If an encumbrance (unknown to the buyer or lender prior to closing) does exist and is not listed as an exception in the policy, a claim against the insurer in excess of the policy limits cannot be based on the insurer's *negligent preparation* of the list of encumbrances excluded from coverage in the title insurance policy. Also, a claim on an erroneous preliminary title report (prelim) cannot be based on the negligent preparation of the report. [See Chapter 28]

However, a title insurer might *intentionally write over* encumbrances at the request of a seller. If the buyer is not notified the encumbrance exists, the insurer is liable for actual losses in excess of the policy coverage for breach of the implied covenant of good faith and fair dealing imposed on title companies as a duty owed to their insured, the buyer. [**Jarchow** v. **Transamerica Title Insurance Company** (1975) 48 CA3d 917]

## Introduction to title policy forms

Title insurance is purchased to assure real estate buyers, tenants and lenders the **interest in title** they acquire is what they bargained for from the seller, landlord or borrower. While title insurance is not a guarantee of the condition of the interest acquired in title, it does provide a **monetary recovery** up to the policy's dollar limits for the conveyance of any lesser interest than the interest insured due to unlisted exceptions.

On closing a real estate transaction, a policy of title insurance is issued on one of several prototypical forms used throughout the entire title insurance industry in California. The policies are typically issued

to **buyers** of real estate, **tenants** acquiring long-term leases and **lenders** whose loans are secured by the real estate.

**Two basic forms** exist which are the industry standard for:

- insuring the condition of record title only, accomplished by the issuance of a *California Land Title Association (CLTA) policy*; and
- insuring both the record title and observable on-site activities which affect title, accomplished by the issuance of an *American Land Title Association (ALTA) policy*.

A **policy of title insurance** is broken down into six operative sections, including:

- the **risks of loss covered**, called *insuring clauses*, which are based on a completely unencumbered title at the time of the insured transfer;
- the **risks of loss not covered**, comprised of encumbrances arising after the transfer or known to or brought about by the insured, called *exclusions*, which are a boilerplate set of title conditions;
- **identification** of the insured, the property, the vesting, the estate in the property, the dollar amount of the coverage, the premium paid and the policy (recording) date for the conveyance insured, called *Schedule A*;
- the **recorded interests**, i.e., any encumbrances affecting title and any observable on-site activities which are **listed as risks** agreed to and assumed by the insured and not covered by the policy, called *exceptions*, which are pre-printed for CLTA coverage and itemized for all types of coverage in *Schedule B*;
- the **procedures**, called *conditions*, for **claims made** by the named insured and for *settlement* by the insurance company on the occurrence of a loss due to any encumbrance on title which is not an exclusion or exception to the coverage initially granted by the insuring clauses; and
- any **endorsements** for additional coverage or removal of exclusions or pre-printed exceptions from the policy.

## Insuring clauses

Coverage under the broadly worded **insuring clauses** of a policy of title insurance indemnifies the named insured for risks of loss **related to the title** due to:

- anyone making a claim against title to the real estate interest;
- the title being unmarketable for sale or as security for financing;
- any encumbrance on the title; and
- lack of recorded access to and from the described property.

## Exclusions from coverage

All title insurance policies, in their **exclusions section**, eliminate from coverage those losses incurred by the insured buyer, tenant or lender due to:

- **use ordinances** or (zoning) laws;
- **unrecorded claims known** to the insured, but not to the title company;
- encumbrances or adverse **claims created** or attaching **after** the date of the policy;
- claims arising out of **bankruptcy** laws or due to a **fraudulent conveyance** to the insured;
- police power and **eminent domain**; and
- **post-closing events** caused by the insured.

### Schedule A data

All policies of title insurance on **Schedule A** set forth:

- the property interest the insured acquired (fee simple, leasehold, life estate, security, etc.);
- the legal description of the insured property;
- the date and time the insured conveyance or lien recorded and coverage began;
- the premium paid for the policy; and
- the maximum total dollar amount to be paid for all claims settled.

## Exceptions to coverage

In addition to the policy exclusions, a policy's coverage under its "no-encumbrance" insuring clause is further limited by **Schedule B** exceptions in the policy. The **exceptions section** contains an itemized list of recorded and unrecorded encumbrances which are known to the title company and affect the insured title. While the existence of these known encumbrances are insured against in the insuring clauses, they are removed by Schedule B as a basis for recovery under the policy.

In addition to the itemized **list of exclusions**, an American Land Title Association (ALTA) policy includes a set of pre-printed exceptions setting forth risks assumed by the insured buyer, tenant or lender, which include:

- taxes, assessments, liens, covenants, conditions and restrictions (CC&Rs), or any other interests, claims or encumbrances which have not been recorded with the county recorder or tax collector on the date of closing;
- any unrecorded and observable on-site activity which includes conflicts regarding boundary lines, encroachments or any other facts which a correct survey would disclose;
- unpatented mining claims; and
- all water rights.

## Claims and settlements

Lastly, a policy of title insurance includes a **conditions section** which outlines the procedures the named insured must follow when making a claim for recovery under the policy. Also set forth are the settlement negotiations or legal actions available to the title company before they must pay a claim.

**Figure 1** *Excerpt from **first tuesday** Form 150*

12.4 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under an ALTA form policy issued by ________________ as a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming Carryback Seller or purchase-assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements:________________________________________________

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

## Owner's policies for buyers

Several types of title coverage are available for a buyer to choose from when entering into a purchase agreement with the seller, including:

- a California Land Title Association (CLTA) standard policy;
- an American Land Title Association (ALTA) owner's extended coverage policy;
- an ALTA residential (ALTA-R) policy; and
- an ALTA homeowner's policy.

When making an offer, a prospective buyer is informed by his agent about the coverage each type of policy provides. The buyer's need for title coverage must be reviewed when the buyer enters into a purchase agreement since the agreement's title insurance provision calls for the buyer to designate the type of title insurance policy on closing and states who will pay its premium. [See Figure 1]

The buyer's choice of a title policy as selected in the purchase agreement may depend on who is paying the title insurance premium — the buyer or the seller. Customarily, the seller pays the premium, except in some northern California counties.

Whoever will pay the policy premium is disclosed and accounted for in the brokers' disclosures to sellers and buyers of the net proceeds and costs to be expected on closing. [See **first tuesday** Forms 310 and 311]

Unless requested by the escrow holder when ordering a policy under escrow instructions, the tendency of title insurance companies is to issue the more expensive ALTA coverage policies. This condition is permitted by real estate brokers when using purchase agreement forms designed in collaboration with the title insurance industry. Here, the ALTA policy is the **default policy**.

## The CLTA standard policy

The California Land Title Association (CLTA) standard policy is purchased solely by buyers, carryback sellers and private lenders, not institutional lenders or builders who generally need extended coverage.

The CLTA standard policy insures against all encumbrances affecting title to the property which can be discovered by a search of **public records** prior to issuance of the policy. Any encumbrance not recorded, whether or not observable by an **inspection or survey** of the property, is not covered due to the CLTA policy exclusions and standard exceptions.

**Public records** include those records which impart *constructive notice* of encumbrances affecting title to the property.

For example, a deed conveying a parcel of real estate which is actually **recorded and indexed** by the county recorder's office imparts constructive notice to buyers and lenders who later acquire an interest in the property. [Calif. Civil Code §1213]

Additionally, the CLTA standard policy (as well as the American Land Title Association (ALTA) policy) protects the insured against:

- the unmarketability of title or the inability to use it as security for financing;
- lack of ingress and egress rights to the property; and
- losses due to the ownership being vested in someone other than the buyer.

*Excerpt from ALTA Short Form Residential Loan Policy Adopted 6/16/07*

# SCHEDULE B

## EXCEPTIONS FROM COVERAGE AND AFFIRMATIVE INSURANCES

Except to the extent of the affirmative insurance set forth below, this policy does not insure against loss or damage (and the Company will not pay costs, attorneys' fees, or expenses) which arise by reason of:

1. Covenants, conditions, or restrictions, if any, appearing in the Public Records; however, this policy insures against loss or damage arising from:

   (a) the violation of those covenants, conditions, or restrictions on or prior to Date of Policy;

   (b) a forfeiture or reversion of Title from a future violation of those covenants, conditions, or restrictions, including those relating to environmental protection; and

   (c) provisions in those covenants, conditions, or restrictions, including those relating to environmental protection, under which the lien of the Insured Mortgage can be extinguished, subordinated, or impaired.

   As used in paragraph 1(a), the words "covenants, conditions, or restrictions" do not refer to or include any covenant, condition, or restriction (a) relating to obligations of any type to perform maintenance, repair or remediation on the Land, or (b) pertaining to environmental protection of any kind or nature, including hazardous or toxic matters, conditions, or substances, except to the extent that a notice of a violation or alleged violation affecting the Land has been recorded or filed in the Public Records at Date of Policy and is not referenced in an addendum attached to this policy.

2. Any easements or servitudes appearing in the Public Records; however, this policy insures against loss or damage arising from (a) the encroachment, at Date of Policy, of the improvements on any easement, and (b) any interference with or damage to existing improvements, including lawns, shrubbery, and trees, resulting from the use of the easements for the purposes granted or reserved.

3. Any lease, grant, exception, or reservation of minerals or mineral rights appearing in the Public Records; however, this policy insures against loss or damage arising from (a) any affect on or impairment of the use of the Land for residential one-to-four family dwelling purposes by reason of such lease, grant, exception or reservation of minerals or mineral rights, and (b) any damage to existing improvements, including lawns, shrubbery, and trees, resulting from the future exercise of any right to use the surface of the Land for the extraction or development of the minerals or mineral rights so leased, granted, excepted, or reserved. Nothing herein shall insure against loss or damage resulting from subsidence.

All title insurance policies provide coverage forever after the date and time the policy is issued, limited in recovery to the dollar amount of the policy, which is generally adjusted for inflation. Coverage is further limited by the **exclusions, exceptions and conditions on claims**.

The CLTA standard policy (as well as the ALTA policy) contains Schedule A *exclusions to coverage* which bar recovery by the buyer or joint protection carryback seller for losses due to:

- zoning laws, ordinances or regulations restricting or regulating the **occupancy, use or enjoyment** of the land;
- the character, dimensions or location of any **improvement erected** on the property;
- a **change in ownership** or a parceling or combining of the described property by the insured buyer;
- **police power**, eminent domain or violations of environmental protection laws, unless a notice or encumbrance resulting from the violation was recorded with the county recorder before closing;
- encumbrances **known** to the insured buyer or lender which are not recorded or disclosed to the title company;
- encumbrances which do not result in a **monetary loss**;
- encumbrances which are created or become encumbrances **after issuance** of the policy;
- encumbrances resulting from the buyer's payment of **insufficient consideration** for the property or delivery of improper security to the lender also insured under the policy; and
- the unenforceability of the insured trust deed lien due to the lender's **failure to comply** with laws regarding usury, consumer credit protection, truth-in-lending, bankruptcy and insolvency.

The CLTA standard policy contains **pre-printed exceptions** listed in the policy as Schedule B, also called *standard exceptions* or *regional exceptions*. It is the inclusion of these pre-printed boilerplate exceptions which makes the CLTA policy a standard policy. An ALTA owner's policy does not contain pre-printed exceptions, only the typewritten exceptions listing the encumbrances which are known to the title company and affect title to the property.

The **pre-printed standard exceptions** in Schedule B of the CLTA standard policy eliminate coverage for losses incurred by the buyer due to:

- taxes or assessments not shown as existing liens in the records of the county recorder, the county tax collector or any other agency which levies taxes on real property;
- unrecorded rights held by others which the buyer could have discovered by an inspection of the property or inquiry of persons in possession;
- easements or encumbrances which are not recorded and indexed by the county recorder;
- unrecorded encroachments or boundary line disputes which would have been disclosed by a survey; and
- recorded or unrecorded, unpatented mining claims or water rights.

A lower premium is charged to issue a CLTA policy since the title company undertakes a lower level of risk for indemnified losses due to the CLTA pre-printed exceptions as compared to the extended risks covered by the more expensive ALTA owner's policy.

## The ALTA owner's policy and survey

Most policies issued today are of the American Land Title Association (ALTA) variety since the California Land Title Association (CLTA) policy format with pre-printed standard exceptions does not provide protection for **unrecorded encumbrances or claims** to title.

The ALTA owner's policy provides greater coverage (and requires greater premiums) than the CLTA policy since the exceptions in Schedule B do not include the pre-printed standard exceptions. If the pre-printed exceptions are included in Schedule B and attached to the ALTA policy, the policy becomes an ALTA standard policy, comparable in cost and coverage to the CLTA standard policy since unrecorded encumbrances will not be covered.

The ALTA owner's policy covers **off-record matters** not covered under the CLTA standard policy. As a result, the title company may require the parcel to be surveyed, and those in possession of the property to be interviewed or estopped, before the title company will issue an ALTA policy. Unrecorded interests in title are most often observable by an on-site inspection of the property.

Typewritten exceptions for existing encroachments or boundary conflicts are occasionally added to the ALTA policy (Schedule B) based on the survey.

The exclusions section of an ALTA owner's policy are identical to exclusions in the CLTA policy, except for additional exclusions relating to an insured lender or carryback seller. The ALTA owner's policy is not issued to secured creditors. More precisely, a joint protection ALTA policy is never issued.

Thus, separate policies and duplicate premiums are required for a lender's ALTA coverage when a buyer of property records a new loan.

The premium for an ALTA owner's policy is larger than the premium for a CLTA standard policy. The ALTA owner's policy provides additional coverages and may, as a requisite to issuance, require costs to be incurred for a survey.

Further, the premium is nearly doubled to pay for both a lender's policy and the buyer's policy when a new loan is recorded to fund the purchase of real estate acquired by the buyer. This is not the case for a CLTA joint protection policy covering both the lender and the buyer.

## The ALTA residential policy

For buyers of parcels of real estate containing one-to-four residential units, an American Land Title Association Residential (ALTA-R) policy is available in lieu of the ALTA owner's or homeowner's policies. Parcels insured include lots and units in common interest developments (CIDs), such as condominiums.

The ALTA-R is referred to by the title companies as the *"plain language"* policy. The ALTA-R is written using wording which avoids legalese. The policy is structured and written to be easily read and understood by the average buyer. Also, the ALTA-R policy contains a **table of contents** and an **owner's information sheet** which outlines the policy's features.

The coverage, exclusions and exceptions in the ALTA-R policy are similar to the ALTA owner's policy. In addition, the ALTA-R policy covers losses due to:

- mechanic's liens incurred by someone other than the buyer; and
- the inability of the buyer to occupy the property should the single family residence violate the conditions, covenants and restrictions (CC&Rs) listed in the Schedule B exceptions in the policy or existing zoning.

The premium for an ALTA-R policy is priced lower than the premium for an ALTA owner's policy since the ALTA-R policy is usually issued only on parcels in an existing subdivision or CID which has no known problems with easements, encroachments or legal access.

## The ALTA homeowner's policy

A **homeowner's policy** now exists to provide **more coverage** than the American Land Title Association (ALTA) owner's or the American Land Title Association Residential (ALTA-R) policies. In addition to the risks covered by the ALTA owner's and ALTA-R policies, the homeowner's policy covers several risks to ownership which could arise **after closing**, including:

- the **forging** of the buyer's signature on a deed in an attempt to sell or encumber the buyer's property;
- the construction on an adjoining parcel of a structure which **encroaches** onto the buyer's property, excluding a boundary wall or fence;
- the recording of a document which prevents the buyer from obtaining a secured loan or selling the property;
- claims of **adverse possession** or **easement by prescription** against the buyer's property; and
- claims by others of a right in the buyer's property arising out of a lease, contract or option **unrecorded and unknown** to the buyer at the time of closing.

The ALTA homeowner's policy also covers losses arising out of a lack of **vehicular and pedestrian access** to and from the property. Other owner's policies only cover losses resulting from the lack of a legal right to access, not a practical means of access which is covered by the ALTA homeowner's policy.

Also covered by the ALTA homeowner's policy are losses incurred due to many other risks which may exist at the time of closing, including:

- the correction of any pre-existing violation of a condition, covenant and restriction (CC&R);
- the inability to obtain a building permit or to sell, lease or use the property as security for a loan due to a pre-existing violation of a subdivision law or regulation;
- the removal or remedy of any existing structure on the property if it was built without obtaining a building permit, excluding a boundary wall or fence;
- damage to existing structures due to the exercise of a right to maintain or use an easement;
- damage to improvements due to mineral or water extraction;
- the enforcement of a discriminatory CC&R;
- the assessment of a supplemental real estate tax due to construction or a change of ownership or use occurring before closing;
- an incorrect property address stated in the policy; and
- the map attached to the policy showing the incorrect location of the property.

Encumbrances relating to the insured title and known to the title company will be itemized in the policy as additional exceptions which limit coverage. The exceptions should be reviewed by the buyer and the buyer's broker in a preliminary title report before closing and issuance of a policy.

The ALTA homeowner's policy contains the same exclusions from coverage stated in the ALTA-R policy, plus an exclusion for any **building code violations**, unless notice of the violation has been recorded with the county recorder (in which case it would be known to the title company and listed as an exception).

Before a ALTA homeowner's policy will be issued by a title insurer, two requirements must be met:

- the property must be *improved* with a one-to-four unit family residence; and
- the buyer must be a natural person, not an entity such as a corporation, limited liability company (LLC) or partnership.

Many title insurance companies use the ALTA homeowner's policy as their "default policy," which they will issue if a specific title policy is not requested by escrow. The premium for the policy is approximately 10% more than the California Land Title Association (CLTA) owner's policy.

Unless the buyer (or seller) calls for a CLTA standard policy, ALTA owner's or ALTA-R policy in the purchase agreement and escrow instructions, the title company will, by the default of the escrow, automatically issue the more expensive policy.

### Binders for resale on a flip

An investor who buys property and plans on reselling it within two years after his purchase should be advised by the buyer's agent to consider a binder, also called a *commitment to issue.*

A binder entitles the buyer to title insurance coverage until the buyer requests a policy be issued to a new buyer on resale of the property or to a new lender on a refinance. An example is a relocation agent (broker) who temporarily takes title to a residence before it is resold to the ultimate buyer or an investor who intends to flip the property.

With a binder, the resale policy will be at no further charge, except for additional liability coverage requested for any increase in the resale price or loan amount.

### Lender policy options

The California Land Title Association (CLTA) and American Land Title Association (ALTA) title policies available to insure the priority of the lien a lender holds to secure their loan, include:

- a CLTA standard joint protection (JP) policy; and
- an ALTA loan policy.

### The CLTA standard JP policy

A lender or seller who carries back a note and trust deed for part of the sales price has options when calling for title insurance.

The lender or carryback seller can either:

- be named as an additional insured on a California Land Title Association (CLTA) standard joint protection (JP) title insurance policy with the buyer; or
- request a separate American Land Title Association (ALTA) loan policy as a only named insured.

The JP policy enables one or more individuals or entities to be named as insured.

In addition to the owner's standard CLTA title coverage, the JP policy provides coverage for a trust deed held by a lender or carryback seller. Thus, the JP policy indemnifies the lender or carryback seller against losses arising from risks such as:

- the invalidity or unenforceability of the insured creditor's trust deed lien;
- the priority of a lien or other encumbrance which was not listed in the policy exceptions; and
- the invalidity or unenforceability of an assignment of the insured trust deed when the assignment is listed in the exceptions as affecting the trust deed.

If a loss covered by a JP policy occurs, the named insureds suffering from the loss will share in any recovery up to the dollar limit of the policy, subject to disbursements based on their priority or pro rata

interest between themselves in title. Thus, recovery by both the owner and the secured creditor under the JP is not cumulative, nor should it be.

Accordingly, no windfall occurs since title policies only indemnify an insured against the insured's actual monetary loss. If there is no loss of value, there is no basis for recovery.

Most **policy limits** are established based on the value of the property, and as part of that value, the loan amount. Thus, the owner and the lender are fully protected under a JP policy since the aggregate value of their interests (debt and equity) do not exceed the policy limits on closing.

Accordingly, once a policy loss has been paid to an insured owner, lender or carryback seller, the amount of coverage under the policy is reduced.

However, the JP policy is only available under a CLTA standard policy. If either the buyer or lender in a cash-to-new-loan transaction requests ALTA coverage, a separate ALTA loan policy will be issued to each at approximately double the cost.

### The ALTA loan policy increases costs

An institutional lender will usually require its trust deed lien on a parcel of real estate to be insured under an American Land Title Association (ALTA) loan policy as a condition for making a loan secured by real estate.

The ALTA loan policy insures against money losses incurred by lenders and carryback sellers due to the loss of priority of the insured trust deed lien, unless listed in the exceptions, to encumbrances such as:

- a mechanic's lien, if the work was commenced prior to recording the trust deed (which is the same date and time as the date of the policy) and the trust deed did not secure a loan to pay for the construction;
- a mechanic's lien arising out of work financed by proceeds from the construction loan secured by the insured trust deed, if no part of the construction work was commenced before the trust deed was recorded; and
- assessments (Mello-Roos) for street improvements under construction or completed prior to recording the trust deed.

However, the ALTA policy does not cover losses resulting from lack of priority of the insured trust deed to a mechanic's lien if:

- the secured loan was not a construction loan designed to finance construction; and
- no part of the construction work which led to the mechanic's lien commenced before the trust deed was recorded.

ALTA **exclusions** in lender policies eliminate coverage for claims arising out of a loan transaction due to the operation of federal bankruptcy law, state insolvency or similar creditors' rights laws, if the claims are based on:

- a *fraudulent conveyance* to the vested owner to conceal assets;
- the *equitable subordination* (a court ordered assignment) of the insured lender's lien; or
- the insured lender's trust deed being deemed a *preferential transfer* by a bankruptcy court due to the recording of the trust deed within 90 days before a bankruptcy filing.

The ALTA loan policy comes at a higher (and separate) premium than the California Land Title Association (CLTA) standard joint protection (JP) policy due to the extended mechanic's lien and assessment

coverage, the need to pay premiums on two title policies and the cost of any survey required before issuing a title insurance policy. A buyer who borrows funds to finance his purchase usually pays the premium for the lender's policy.

## Endorsements for special occasions

*Endorsements* of great variety can be added to title insurance policies to provide coverage for title conditions and use or economic conditions not covered by the prototypical policies. **Endorsements** are usually issued only to lenders, though modified endorsements can be used in owner's policies as well, particularly for developers and builders.

Endorsements cover losses incurred due to violations of conditions, covenants and restrictions (CC&Rs), damage from extraction of water or minerals, mechanic's liens, encroachments (conditions covered in an American Land Title Association Residential (ALTA-R) policy) and the effects of inflation. Endorsements are also issued to remove an exclusion or exception which is an unwanted boilerplate provision in a policy.

## Who is insured?

Those insured under the California Land Title Association (CLTA) standard policy, American Land Title Association (ALTA) owner's policy or American Land Title Association Residential (ALTA-R) policy, include the name of the insured in **Schedule A** and those **who succeed** to the interest of the named insured by *operation of law*, not by purchase, including:

- heirs;
- distributees;
- devisees;
- joint tenancy or community property survivors;
- personal representatives;
- next of kin by intestate succession; and
- corporate or fiduciary successors.

If title is to be transferred to another vesting, concurrently or within a few months, request should be made the title company to include that vesting as a named insured by endorsement.

However, the ALTA homeowner's policy requires the insured and any covered successor to be **an individual** or the trustee of an inter vivos (living) trust, not an entity such as a Limited Liability Company (LLC). A transfer of title by an insured to their revocable inter vivos trust is covered by the ALTA homeowner's policy without endorsement. This is not the case for other policies.

A policy covering an owner does not cover a buyer who purchases the insured property from the owner. A new policy must be obtained, unless the seller holds a **binder** and uses it to issue a policy in the name of the buyer.

Those insured under a lender's policy of title insurance include:

- the lenders described in the policy;
- future purchasers of the insured trust deed, except assignees who acquire the trust deed as a result of an indemnity, guaranty, other policy of insurance or bond held by the insured lender; and
- any government agency — such as Housing and Urban Development (HUD) and the Veterans Administration (VA) — which insures or guarantees the loan secured by the insured trust deed.

A lender's policy also insures:

- the lender's ownership of the described real estate due to a foreclosure or a deed-in-lieu of foreclosure;
- a parent or wholly owned subsidiary of an insured corporation who acquires the insured corporation's lien by operation of law (merger or spinoff), but not by purchase; and
- a government agency which acquires any interest in the insured lien as a result of mortgage insurance or guarantee.

### Settling a claim

To begin the claims process, the insured, on becoming aware of an encumbrance covered as a loss by the policy of title insurance, must promptly give the title insurance company written **notice of claim**.

Upon being notified of the claim, the title company has 15 days to:

- acknowledge receipt of the claim or pay the claim;
- provide the insured with all forms, instructions, assistance and information necessary to prove up the claim; and
- begin any investigation of the claim. [10 Calif. Code of Regulations §2695.5(e)(1-3)]

Further, the insured must provide the title company with a *proof-of-loss statement* within 90 days after incurring the loss. The statement must set forth the encumbrance discovered, the amount of the loss, and the basis for calculating the loss. The title company may also require the insured party to make available records, checks, letters, contracts, insurance policies and other papers related to the claim.

After receipt of the 90-day **proof-of-claim statement**, the title insurance company has 40 days to **accept or reject** the claim, in whole or in part. [10 CCR §2695.7(b)]

On accepting a claim as one covered by the policy, the title company may handle the claim in one of several ways, including:

- **pay policy limits**, plus any authorized costs, attorney fees and expenses incurred by the insured;
- **pay the loss** incurred by the insured, plus costs, attorney fees and expenses;
- negotiate a **settlement**;
- bring or defend a **legal action** on the claim; and
- for an insured lender, **purchase the loan** from the lender for the amount owed by the borrower, plus any authorized costs, attorney fees and expenses incurred by the insured lender.

No payment will be made under a policy without **producing the policy** for payment. If the policy has been lost or destroyed, proof a policy existed must be furnished to the satisfaction of the title company. The documents insured, such as a grant deed or trust deed, contain on their face the title insurer's name and policy number.

Finally, the loss must be paid within 30 days after the loss has been established. [10 CCR §2695.7(h)]

### Extent and limitation of liability

The **conditions section** of a title insurance policy limits the amount the title company is required to pay to settle a claim made by an insured owner, tenant or lender.

**For owners**, the title company can settle a claim by paying the lesser of:

- the full dollar amount of the policy; or
- the reduction in value of the insured's ownership interest caused by the title defect or encumbrance not listed in the policy exceptions which were missed by the title company.

**For lenders**, the title company can settle a claim by paying the lesser of:

- the full dollar amount of the policy;
- the impairment or reduction in value of the security interest due to the title defect or encumbrance not listed in the policy exceptions; or
- the amounts due on the unpaid loan at the time of the loss caused by a defect or encumbrance not listed in the policy exceptions.

The title company will not pay a claim:

- if the title company is able to remove the encumbrance from title;
- until any litigation over the encumbrance has become final; or
- if the owner or lender settles the claim without written permission of the title company.

Additionally, if the lender is the insured, the title company will not cover additional loan amounts which become secured by the trust deed after the insured trust deed is recorded, called *future advances*.

**Future advances** made by lenders are covered if the advances are:

- on an insured construction loan;
- to foreclose on a loan;
- to protect title to their lien rights; or
- to preserve the real estate from impairment.

All payments made by the title insurance company to pay claims, except payments made for costs, attorney fees and expenses, reduce the dollar amount of coverage remaining under the title policy.

## Underinsured and apportioned losses

In addition to all the limitations on the title company's obligation to pay under a policy, the American Land Title Association (ALTA) owner's policy contains *underinsurance* and *apportionment* provisions. These provisions further limit payout by the title company by shifting a percentage of the loss to the insured. **Underinsurance** and **apportionment** provisions are not contained in policies other than ALTA owner's policies since other policies are not issued on large projects.

The **underinsurance provision** of the ALTA owner's policy is triggered when a claim is made, if:

- the amount of the policy limits is less than 80% of the value of the insured real estate or security interest on the date the policy was issued, which arises if the policy is for less than the price paid for the property; or
- an improvement has been erected on the real estate after issuance of the policy which increases the value of the property by at least 20% over the policy limits.

Thus, the underinsurance provision subjects the recovery on any partial loss to the following:

- the title company pays a pro rata amount based on the percentage that the policy limit is of the property value at the time the policy was issued, when improvements have not been made; or
- if improvements have been made, the title company pays a pro rata amount based on the percentage that 120% of the policy limits represents of the total of the policy limits (usually the price paid for the property) and the cost of the improvement.

The underinsurance provision does not apply to costs, attorney fees or expenses which the title company pays under the ALTA owner's policy. Further, the underinsurance provision only applies to that portion of any loss which exceeds 10% of the policy limits.

For example, an owner of a property valued at $2,000,000 on the date of the policy receives an ALTA owner's title policy with a policy limit of $1,400,000. The owner erects no improvements on his property. An undisclosed encumbrance on title results in a loss of $600,000. The owner of the property seeks recovery from the title company.

According to the underinsurance provision in the ALTA owner's policy, the owner would not be indemnified for the entire loss. Only $462,000 will be paid, being 10% of the policy limit, plus a percentage of the remaining loss based on a policy-limits to property-value ratio.

The amount of the loss which exceeds 10% of the policy limit is $460,000 ($600,000-$140,000 = $460,000). The percentage the policy limit represents of the property value on the date of the policy is 70% ($1,400,000/$2,000,000 = 70%).

Accordingly, the title company pays $140,000 (10% of the policy limit) and $322,200 (70% of the $460,000 remaining loss) for a total settlement of $462,000 on the $600,000 loss.

The ALTA owner's policy **apportionment provision** further limits the title company's pay out. The apportionment provision is triggered when the insured property consists of two or more parcels which have not been combined for use as a single site. If a loss affects less than all of the parcels, the loss will be settled based on each lot's value when the policy was issued as a pro rata share of the policy limit. Improvements made after the date of the policy are excluded.

## Transfer of rights on settlement

On payment of a claim or elimination of the defect or encumbrance, called *settlement*, all the rights the owner may have against any person or property causing the paid loss are assigned to the title company under a *subrogation provision* in the policy.

Further, the title company has the right on settlement to sue, compromise or settle in the name of the insured to enforce the rights assigned to the title company.

Should the title company recover any money by enforcing the rights assigned to them by the owner, the title company will pay any loss sustained by the owner which was not covered or already paid under the policy. The title company retains any recovery remaining after paying the owner's loss.

# Chapter 30 — Real estate can be stolen

*This chapter reviews the scheme for acquiring ownership of property by adverse possession.*

## Adverse possession becomes ownership

While real estate is not an item a thief can pick up and carry off, the ownership or rights in ownership to real estate is capable of being stolen — if you are not first caught **trespassing** and **ejected**. The means by which the law justifies a private taking of another's ownership is known as *adverse possession*.

**Adverse possession** is the only means by which the law will take 100% of an individual's legal or equitable ownership interest in a parcel of real estate and give it to another individual without **compensation**.

The doctrine of adverse possession is based on a social and economic rationale suggesting real estate should not lie idle. An individual who puts another's land to use without interference and pays taxes imposed on the property — *ad valorem* — is allowed to enjoy the benefits of continued long-term possession, namely **ownership**.

The use-it-or-lose-it rationale has remained unchanged since its inception when the doctrine of adverse possession was established to dispossess medieval lords of their stranglehold on fertile farmland in England.

Adverse possession is often confused with and must be **distinguished** from other legal principles establishing control over another's land, such as:

- boundary disputes;
- encroachments;
- easements by necessity; and
- prescriptive easements.

Possession under a rental agreement or lease is the antithesis of adverse possession since they require consent by conveyance of the right to possession. An individual claiming adverse possession will have his claim barred if he occupies the property as a tenant under a rental agreement or lease at any time during his five year claim.

## Boundary disputes distinguished

Adverse possession is not connected with an individual's possession of another's property under the doctrine of *title by agreed boundaries*. [See Chapter 13]

The **agreed-boundary** doctrine applies when uncertainty exists between neighbors concerning the exact location of the legally described boundary between the properties. For example, an individual occupies land, by agreement with his neighbor, which the individual believes to be his own, but is located beyond his legally described lot line onto his neighbor's adjacent property.

Conversely, adverse possession is the **private taking** of another's land and the payment of taxes, knowing it is not yours and without permission from the true owner.

## Encroachments distinguished

Encroachments are similar to boundary disputes. The distinguishing factor between the two is that an **encroachment** is a dispute between owners of adjoining property which results not from a simple misplaced fence or boundary line, but from the location of *improvements* by one property owner which improperly cross over the common boundary line and intrude into his neighbor's property. [See Chapter 15]

The owner of the encroaching improvements will be able to retain the improvements if the encroachment is relatively minor and resulted from the honest mistake of the owner or builder. [See Chapter 15]

## Easement by necessity and prescription

An *easement by necessity* also differs from adverse possession. Easements are based on the *concurrent use* by a non-owner of another's property. By contrast, adverse possession is based on the **exclusive use** of another's property.

Typically, an **easement by necessity** is granted across a property when a neighboring property is unintentionally landlocked from access to a public right of way. [See Chapter 21]

The distinguishing feature of an easement by necessity is that it is granted by court order when no prior use of the easement might have existed. Conversely, adverse possession results from an individual's exclusive use of a property maintained by continuous and uninterrupted possession.

Most easily confused with adverse possession is a *prescriptive easement*. Like adverse possession, a **prescriptive easement** over another's property is an uncompensated *private taking* without the owner's consent.

However, a prescriptive easement only involves the non-exclusive (concurrent) and limited *right to use* another's real estate without any obligation to pay property taxes. On the contrary, **adverse possession** is concerned with acquiring the ownership of real estate with its right to **exclusive possession** and obligation to **pay taxes**. [**Silacci** v. **Abramson** (1996) 45 CA4th 558; see Chapter 21]

## Adverse possession criteria

Any person claiming title to property through **adverse possession** must satisfy specific criteria to *perfect his claim* of ownership. If any portion of the criteria is not met, the adverse possessor's claim to ownership has not been perfected.

The criteria for **perfecting ownership** by an adverse possession claim are:

- a color of title or claim of right to title;
- actual, notorious and open possession;
- hostile, adverse and exclusive use;
- continuous and uninterrupted possession for five years; and
- payment of current and delinquent real estate taxes and assessments. [**Gilardi** v. **Hallam** (1981) 30 C3d 317]

## Color of title or claim of right

Two distinct types of adverse possession claims exist:

- a claim of ownership based on a written instrument, called a *color of title* claim [Calif. Code of Civil Procedure §322]; or
- a claim of ownership made without any documentation, except possession and payment of taxes, called a *claim of right*. [CCP §324]

The **color of title** claim is used to defend the claim of ownership held by the individual in possession of the property. This defense is used against the person who holds recorded title and seeks to:

- wrest possession of the property from the occupant, called an *adverse possessor*; and
- clear title of the cloud created by the document which supports the adverse possessor's color of title claim.

To perfect a color of title claim, the **adverse possessor** presents written documentation demonstrating he is the owner of the property. This documentation need not be valid to support a color of title claim, and typically is defective and unenforceable. The adverse possessor only needs to show he has a good faith belief he is the true owner of the property.

For example, real estate is conveyed by a recorded grant deed to an individual on the distribution of a deceased relative's estate. The individual takes possession of the property and exercises the rights and responsibilities of ownership.

Later, it is discovered the deceased relative in fact was only a lessee, not the record owner of the property, and had no legal title to convey. However, the individual has an adverse possession claim to the property based on the **color of title** since he had a good faith belief the deed he received was valid. [**Helvey** v. **Lillis** (1934) 136 CA 644]

Conversely, adverse possession by **claim of right** attacks the title held by the recorded owner and takes possession of the property with the intent to interfere with that title.

A person whose adverse possession is based on a claim of right is merely a *trespasser* or *intruder* who has taken possession of a property without any belief he is the true owner.

Consider an adverse possessor who takes possession of an unoccupied residential property under a claim of right, then rents the property to a tenant.

The absentee owner of the property seeks to terminate the adverse possessor's occupancy within five years of the adverse possessor taking possession. The owner claims the adverse possessor is a criminal trespasser since he entered the property with the intent of interfering with the owner's property rights. The adverse possessor claims he is not a trespasser since his renting out of the property conferred on him a title by occupancy.

In this example, the adverse possessor is acting as a trespasser. The adverse possessor did not adversely occupy the property (and pay property taxes and any liens arising out of unpaid property taxes) for the five-year period required for his (or his tenant's) possession to ripen into ownership with the right to marketable title. [**People** v. **Lapcheske** (1999) 73 CA4th 571]

Additionally, an individual who has a mistaken but good faith belief he has an ownership interest in a property, but no documents to validate his ownership, establishes his adverse possession claim against the true owner under a claim of right. [**California Maryland Funding, Inc.** v. **Lowe** (1995) 37 CA4th 1798]

An adverse possessor's claim to ownership is based upon his willingness and ability to defend his possession of the property against others who may claim title, including the actual legal owner of record. [**Brown** v. **Berman** (1962) 203 CA2d 327]

Proving ownership by adverse possession based on a claim of right is more difficult than by color of title which relies on title documentation. Evidence of five years of continuous adverse and hostile possession and use by the adverse possessor and the payment of property taxes is required to prove ownership under a claim of right. [**Thomson** v. **Dypvik** (1985) 174 CA3d 329]

### Actual, notorious and open possession

An adverse possessor must show he has been in *actual possession* of the property to which he is claiming ownership. [**Howell** v. **Slauson** (1890) 83 C 539]

**Actual possession** may be by the adverse possessor himself or by a tenant who rents the property from the adverse possessor. [**Palin** v. **Sweitzer** (1937) 8 C2d 329]

If the adverse possession claim is made under a **claim of right**, the adverse possessor must demonstrate his actual possession of the property by one of the following:

- surrounding the property with a substantial, protective enclosure;
- cultivating the property; or
- improving the property. [CCP §325]

A **substantial enclosure** must completely surround the claimed property and restrict access to the property by others, including the legal owner of record. [**Jones** v. **Hodges** (1905) 146 C 160]

The enclosure may be a fence, a natural barrier (such as a body of water), or a combination of each if the enclosure restricts access to the property. [Palin, *supra*]

Further, the enclosure must be **properly maintained** during the period the adverse possessor occupies the property. A fence which has deteriorated over time and is not in repair is an insufficient enclosure to put the legal owner of record on notice that another person is occupying the property. [**Ross** v. **Burkhard Inv. Co.** (1928) 90 CA 201]

An adverse possessor occupying property under *color of title* may show possession through one of the claim of right methods, or he may show that he used the land similar to the usage of like properties in the area. [CCP §323]

For example, an occupant of a property under **color of title** believes he is the true owner of the property based on a conveyance he received. However, the occupant has only cultivated a portion of the property described in the conveyance, leaving the remainder untouched.

Since the document of conveyance, which the occupier believes in good faith gave him title, describes the entire property, he will be deemed to have actual possession of the entire property, even though he only uses a portion of it. [CCP §322]

Conversely, a claim of right possessor cultivating land in a situation similar to the preceding color of title example is only able to claim that portion of the entire parcel he cultivated, not the portion of the parcel he left untouched. [CCP §324]

Additionally, the owner of the property against which an adverse possession claim is made must be **on notice** of the possessor's adverse activity regarding the property. This notice may be either *actual* or *constructive*.

**Actual notice** means the owner is personally aware of the occupancy or the adverse possessor's claim against his land.

However, the owner has **constructive notice** if, upon viewing the property, a reasonable person would know the adverse possessor appears to hold some interest in the property due to his occupancy. [**Myran** v. **Smith** (1931) 117 CA 355]

**Hostile and adverse use**

When an individual claims ownership under **color of title**, the existence of a document which purports to vest title in the individual, in conflict with the true title, satisfies the *hostile and adverse* possession requirements.

For possession to qualify as *hostile and adverse* under a **claim of right**, the possession must be without any permission or consent from the legal owner of record, and without regard to any rights of the true owner, which is the case under a lease or tenancy at will.

Consider a wife who holds title and occupies a single family residence, paying all mortgage installments, taxes and maintenance costs. The couple divorces and the husband is awarded the residence.

Title is never vested in the husband, nor does he ask his wife to move out or pay rent. The wife continues to make mortgage payments, pays property taxes and remodels the residence.

More than five years after the divorce is final, the wife lists the property for sale. The husband files an action to have title conveyed to him.

The wife claims she is the owner of the property by adverse possession.

However, the wife is not an adverse possessor since her possession of the property was not hostile and adverse. The husband allowed the wife to use the property as long as she paid all the obligations of ownership. [**Buic** v. **Buic** (1992) 5 CA4th 1600]

Now consider a husband who owns his residence as separate property. Unknown to his wife, he deeds the property to himself and his son from a previous marriage as joint tenants.

Later, the husband dies and the son asks the wife to vacate the residence.

The wife refuses to vacate the residence, claiming the residence is community property and she is now the owner due to her husband's death. The wife makes mortgage payments, pays property taxes and remodels the house. When the son lists the property for sale, she interferes with the "For Sale" signs.

More than five years after the husband's death, a buyer purchases the residence and seeks to eject the wife as a trespasser.

The wife claims she is entitled to ownership of the property under adverse possession. The buyer claims the wife's possession was permitted by the surviving son and is thus not hostile or adverse.

Is the wife's possession hostile and adverse?

Yes! The wife's possession is hostile and adverse since her actions are consistent with her belief that she is the owner of the property and not the son. [California Maryland Funding, Inc., *supra*]

Consider another buyer who constructs a home on a newly subdivided lot and pays all the property taxes. More than five years later, the buyer discovers his home is actually located on land legally described as his neighbor's property.

The buyer's use and improvement of the property are sufficiently hostile and adverse to establish his claim of ownership of the property he occupies, regardless of the true legal ownership. [**Kunza** v. **Gaskell** (1979) 91 CA3d 201]

### Exclusive use

A possessor's *exclusive use* of a property is required to perfect any adverse possession claim, whether based on color of title or claim of right. If another person concurrently or intermittently uses the property without consent from the adverse possessor, the possessor's claim will be defeated.

For example, an adverse possessor who has occupied and used a parcel of real estate seeks to perfect his ownership interest by adverse possession. However, without permission from the adverse possessor, a neighboring property owner used the same property for storage and grazing during the period of the adverse possessor's occupancy. Accordingly, the adverse possessor's claim to ownership is denied for lack of **exclusive use**. [Myran, *supra*]

However, the occasional use of the property by the public (i.e., for recreational activities, as a right of way, etc.) will not affect an adverse possession claim. [**Webber** v. **Clarke** (1887) 74 C 11]

### Continuous and uninterrupted use

An adverse possessor must have occupied a property for at least **five years** before he will be able to acquire title through adverse possession. [CCP §325]

Any interruption in the adverse possessor's possession of the property, such as use by another not authorized by the possessor, will negate the continuity of the five-year period, barring an adverse possession claim. [**Laubisch** v. **Roberdo** (1954) 43 C2d 702]

However, the adverse possessor need not be in continuous possession of the property to satisfy the **continuous possession** requirement. Exceptions to the continuous possession requirement include:

- vacancies between tenants of rental property [Montgomery & Mullen Lumber Co. v. Quimby (1912) 164 C 250];
- vacancies of homes built on subdivided property and not immediately sold [**Blume** v. **MacGregor** (1944) 64 CA2d 244]; and
- off-season vacancies of property used for agriculture or grazing. [**Park** v. **Powers** (1935) 2 C2d 590]

*Continuous possession* by an adverse possessor acting under a **claim of right** must encompass a constant, definable portion of the property. The claim-of-right possessor's use of different portions of a property at different times for a total of five years will not satisfy the continuity requirement.

For example, an adverse possessor, relying upon a claim of right, who uses part of a property for two years, then uses a different part of the property for three years, has not satisfied the five-year requirement. [**Zimmer** v. **Dykstra** (1974) 39 CA3d 422]

### Payment of taxes

An adverse possessor must demonstrate he has **paid all taxes** due on the property during each year of his five year qualifying occupation. [CCP §325]

Additionally, the adverse possessor must pay any **back taxes** owed on the property when he took possession. [**City of Los Angeles** v. **Coffey** (1966) 243 CA2d 121]

In a situation where the taxes are assessed to both the true owner and the adverse possessor, the requirement will be satisfied if the adverse possessor pays the taxes which are assessed to him, without regard to their payment by the true owner. [**Cummings** v. **Laughlin** (1916) 173 C 561]

If the taxes are assessed only to the owner, the adverse possessor must pay the taxes before the **owner pays** them. Paying taxes after the owner will not satisfy the payment of taxes requirement and the possessor will not be able to obtain legal title through adverse possession. [**Carpenter** v. **Lewis** (1897) 119 C 18]

# Chapter 31 Community property rights

*This chapter explains the effect a marriage has on a spouse's ability to sell or encumber real estate.*

### Brokers have a role to play

A broker who represents a married individual in a sale, purchase, lease or financing of community real estate must know whether the performance of the married individual under a listing (paying the fee) or purchase agreement (closing escrow) can be negated by community property defenses held by the other spouse. If so, they can inflict a loss on the broker.

For example, a broker obtains an *exclusive right-to-sell listing* signed only by the wife. The real estate listed is community property, vested in the name of the husband and wife as joint tenants.

During the listing period, the husband and wife sell the property themselves without providing for payment of a fee to the listing broker. The **exclusive listing** agreement entitles the broker to a fee if the property is sold by anyone, including the husband and wife, during the listing period. [See **first tuesday** Form 102 §4.1(a)]

The broker claims both the husband and wife are liable for the brokerage fee since the property is a community asset and was sold during the listing period.

The wife claims the listing is unenforceable without the husband's signature since the property listed cannot be sold and conveyed without her husband's written consent.

Is the broker entitled to his fee?

Yes! While the husband, who did not sign the listing agreement, is not personally liable for the brokerage fee, the wife is liable for the fee. The wife signed the exclusive listing agreement employing the broker to render professional services to market the property and locate a buyer. The broker's enforcement of his fee agreement under the listing is an action for money due on an employment agreement, not an action for specific performance to deliver title under a real estate purchase agreement — which would require both spouses' signatures. [**Tamimi** v. **Bettencourt** (1966) 243 CA2d 377]

### Judgment against a spouse

Continuing with our previous example, on recording an *abstract of judgment* against the wife for the brokerage fee, the judgment becomes a lien on **any community real estate** owned by the couple. However, the husband's separate property is not liened and is unaffected by the abstract.

Consider a husband who encumbers community property with a trust deed, executed by the husband alone and without the consent of his wife, to secure a note which evidences a loan.

Later, the trust deed held by the lender is set aside in an action by the wife to clear title of the trust deed since the wife did not consent to the encumbrance (financing) of the community property.

The husband defaults on the now unsecured loan. The lender obtains a money judgment against the husband and records an abstract of judgment.

The abstract now attaches as a lien to all community real estate, including the same community property which had been previously encumbered by the voided trust deed.

Later, the couple's marriage is dissolved and the wife is awarded sole ownership of the community property which had been cleared of the trust deed lien.

The wife claims the money judgment lien cannot attach to the property since the debt which became the money judgment had been secured by the same property under a trust deed the court declared void.

However, when the abstract of judgment against the husband was recorded, the abstract created a valid lien on all of their community property, including the property now solely owned by the wife. The judgment attached to the property while it was still community property, before the dissolution of the marriage. [**Lezine** v. **Security Pacific Financial Services, Inc.** (1996) 14 C4th 56]

## Transfer by transmutation

A husband and wife divide their community assets between themselves so they can conveniently pass the assets on to their children from previous marriages.

The husband and wife do not provide for the division of the funds received by the husband from his pension fund. However, the money from the pension fund is community property, even though the pension is vested only in the husband's name.

The husband places the **pension funds** into an individual retirement account (IRA) vested in the name of the husband's revocable inter vivos (living) trust. The husband obtains the wife's consent to the deposits, acknowledging she is not to be named as a beneficiary on the IRA account.

Years later, the wife asserts an interest in the IRA, claiming the funds are community property.

The husband claims the wife *transmuted* her community property interest into his separate property when she signed the consent form for the change in vesting.

Does the wife have a community property interest in the husband's IRA?

Yes! For a written declaration to express an intent to **transmute property** from a community asset to a separate asset of one spouse, the declaration signed must contain an **explicit statement** confirming the spouse *conveys and terminates* the community property interest held in the property.

The use of the word "transmutation" is not required in a **transfer document** to transmute property. A transmutation would have taken place had the consent agreement contained the provision, "I give to the account holder any interest I have in the funds deposited in this account." [**In re Estate of MacDonald** (1990) 51 C3d 262]

Consider a husband and wife who buy property with money each earned during their marriage. Escrow is instructed to vest title to the property in the wife as her sole and separate property.

Concurrent with the recording of the grant deed to the wife, the husband signs a quitclaim deed (or joins in the grant deed as the husband of the grantee) clearing title of any interest he may have in the property.

Later, the property is sold and the wife's conveyance is insured by a title company as a transfer of the entire fee ownership of the property. The husband does not sign and record another quitclaim deed, or join in the wife's conveyance.

The title insurance company considers the husband's deed on his wife's acquisition of title to the property to be the only conveyance required since the quitclaim deed was recorded.

Within one year after recording the wife's conveyance, the husband seeks to set aside the sale as voidable. The husband claims the original quitclaim deed was not a transmutation of their community property into the separate property of his wife since they only intended to vest the property so his name did not appear of record.

Is the quitclaim deed a written declaration which changed the characteristics of the property from community to separate ownership by the other spouse?

Yes! The husband's *execution* (signature and delivery) of the **quitclaim deed** transferred his interest in the community property to his wife as her separate property since the deed released all interest he held in the property. Thus, the spouse's quitclaim deed transmuted the community property into the separate property of the other spouse. [**In re Marriage of Broderick** (1989) 209 CA3d 489]

A **transmutation occurs** when a married individual or couple transfers personal or real property from:

- community property to a separate property interest of one spouse;
- a separate property interest of one spouse to community property; or
- a separate property interest of one spouse to the separate property interest of the other. [Calif. Family Code §850]

### Unrecorded transmutations

A transmutation must be *written and recorded* to be effective against persons relying on the record title. The recording requirement gives **notice to others** who rely on the recorded title (such as title insurance companies, buyers, tenants or lenders) and whose rights may be affected by a transmutation (such as family members). [Fam C §852]

For example, an individual acquires property as his sole and separate property.

Later, the individual marries. The individual, now a spouse, transmutes his separate property to community property by handing his wife a signed deed from himself granting the property to himself and his spouse, as husband and wife. However, the deed which transmuted the property is never recorded.

Later, the husband sells and conveys the property. Within one year after the sales transaction closes, the wife seeks to set aside the sale, claiming she did not consent to the sale of the community real estate as evidenced by the unrecorded deed.

The buyer claims he (and his title insurer) can rely on the record title which showed the property to be vested only in the husband as his sole and separate property.

Can the sale of the community property be set aside by the wife?

No! The transmutation of the husband's separate property to community property was never recorded. Thus, the buyer (and the title insurer) can rely upon the record title. [Fam C §852(b)]

*Editor's note — This situation is unlikely to occur unless the broker representing the buyer knows the transmutation rules and presses the title company to issue a policy. Title insurance companies do not readily insure the conveyance by a spouse who is the sole vested owner until the off-record spouse delivers a quitclaim deed or joins in the conveyance.*

*However, no reported case or statute suggests a community interest accrues which can be adjudicated and enforced against a buyer or a lender. Title companies insuring conveyances on property acquired post-1984 or acquired prior to a post-1984 marriage can and should rely on the record title.*

## Community status imputed to buyer

Both spouses must consent to a *sale, lease* for more than one year or *encumbrance* of community real estate. [Fam C §1102]

If one spouse, without the consent of the other, sells, leases for more than one year or encumbers community real estate, the nonconsenting spouse may either *ratify* the transaction or have it *set aside*. The nonconsenting spouse has **one year** from the recording of the nonconsented-to transaction to file an action to set it aside. If a third party to the transaction — a buyer, tenant or lender — has no notice of the marriage, the transaction cannot be set aside. [Fam C §1102]

Consider a **buyer's broker** who has knowledge the seller of real estate is married and was married when, in his own name, he acquired the property being sold. The broker does not inform his buyer (or the title company) of the seller's marital status. The property is vested of record in the name of the seller only, with no recorded reference to his married status.

Later, and within one year, the nonconsenting spouse learns of the sale and files suit to void the transaction claiming a community property interest in the real estate. The buyer claims he is a bona fide purchaser, unaware of the marital relationship at the time of the sale.

However, the **knowledge** of the buyer's broker is *imputed* to the buyer since the broker is the buyer's agent. Thus, the nonconsenting spouse is able to set aside the sale of the property, even though the buyer himself was actually unaware of the marriage. [**Waldeck** v. **Hedden** (1928) 89 CA 485]

## LLC as a vesting

To circumvent the need to obtain quitclaim deeds or determine whether a transmutation has occurred, real estate can be vested in a limited liability company (LLC) solely owned by one spouse, or owned by both spouses with only one spouse as the manager of the LLC. [See Chapter 39]

For example, a wife can transfer her separate property to an LLC, and manage and control the property as the manager of the LLC. While the LLC owns the real estate, the wife owns the LLC as its sole member.

As manager, the wife is able to sell, encumber or lease the property in the name of the LLC — without her spouse's consent. [Calif. Corporations Code §§17052(f), 17157]

Other instruments and entities which can be used to authorize one spouse to manage and control community property include:

- a power of attorney;
- a revocable trust in which one spouse is the named trustee [Fam C §761(c)]; or
- a limited partnership. [Corp C §15621]

# Chapter 32 The revocable title holding trust

*This chapter reviews the use of a living trust vesting to avoid probate supervision of a deceased owner's estate, and distinguishes the living trust from other trust arrangements.*

### A review of vestings

A broker, on behalf of a prospective buyer, locates real estate on which the buyer decides to make an offer to purchase.

Before preparing a purchase agreement for the buyer to sign, the broker asks the buyer:

- How are you going to *take title* to the property?; and
- How are you going to fund the good faith deposit?

The buyer informs the broker he will take title in the name of his **family trust**, legally titled a *revocable inter vivos trust agreement* and commonly called a *living trust vesting*. The deposit for the down payment of the purchase price will be made with a check drawn on a bank account in the buyer's name **as trustee** for the living trust.

Due to the buyer's trust vesting requirement, the buyer is told he will need to provide a copy of the trust agreement (or at least the first page) on the opening of escrow. Escrow will need a copy of the trust agreement to confirm the correct name and spelling of both the trustee and the family trust for use when preparing escrow instructions and the grant deed transferring title in the living trust.

The broker, aware the buyer will fund a portion of the purchase price from the net proceeds of a **new loan**, is concerned about the vesting the lender will demand to fund and record the loan.

Since the broker knows the lender will require the buyer to take title in his own name, the broker inquires into the buyer's legal status, asking:

- Are you single, married, unmarried or widowed?; and
- On acquisition, will the property be separate property, community property or a property jointly owned with others?

The buyer informs the broker he is married and the property acquired will be community property.

To avoid vesting complications on closing, the broker informs the buyer that the lender (and the title company) will require **both spouses** to enter into the loan agreements, including the trust deed. Lenders will not accept a living trust as a borrower since a living trust is not a person or legal entity.

Thus, the buyer and his spouse will be required to take title to the property in both their names — husband and wife — as joint tenants, as community property or as community property with the right of survivorship. [See Chapter 34]

Accordingly, the broker enters the names of both the buyer and his spouse as the buyers on the purchase agreement, not naming the family trust as the buyer.

The buyer is advised that after the spouses take title and the lender's trust deed is recorded, a grant deed further conveying the property from the spouses into the family trust vesting can be recorded.

The escrow officer will be instructed to prepare two grant deeds:

- one from the seller to the buyer; and
- one from the buyer to his family trust, to be recorded after the lender's trust deed is recorded.

This "double deeding" instruction is to be part of the mutual escrow instructions signed by the seller and buyer. The lender, on receiving a copy of the escrow instructions, will have notice (as required by federal mortgage law) of the additional transfer into the family trust vesting. [12 Code of Federal Regulations §591.5(b)(1)(vi)]

Additionally, escrow will be advised the policy of **title insurance** is to be issued in the name of the buyer and his spouse as the vested owners. However, only the American Land Title Association (ALTA) homeowner's policy of title insurance automatically provides coverage for a later transfer into the revocable inter vivos trust vesting, even though only the husband and his spouse are named as the insureds. All other title insurance policies require an endorsement to insure a later transfer to the inter vivos (living) trust vesting. [See Chapter 29]

## Reasons for a trust vesting

An individual owner of property, real or personal, creates a **revocable living trust** to hold title to his property for multiple reasons, primarily:

- to accommodate the **distribution** of the owner's estate which remains at the time of the owner's death, without resorting to probate proceedings under a will; and
- to retain the **interim ability** to sell, encumber, lease or remove the property from the trust vesting without the debilities imposed by other estate planning vestings, such as joint tenancy or community property vestings.

Alternatively, spouses who want to best accomplish the passing of their community property to the surviving spouse should use a right of survivorship vesting such as a joint tenancy or community property with right of survivorship vesting. These survivorship vestings eliminate the need for a conveyance from the successor trustee under the living trust on the death of a spouse. Additionally, under these vestings, the **right of survivorship** can be individually *severed* — eliminated — by either spouse. To sever the right of survivorship, either spouse may deed their interest to themselves with a declaration stating they are terminating the joint tenancy or community property with right of survivorship vesting. [See Chapter 34]

The deed to oneself of a fractional ownership interest alters the vesting but does not alter the underlying nature of the ownership, whether it is a community asset or a separate asset. What remains after a spouse **severs** a right of survivorship vesting is a simple community property vesting.

## Judgments attach to trust vestings

A popular misconception maintains that owners can use revocable living trust vestings to avoid their creditors. This is completely unfounded — the trust vesting is not a debt shield or an *asset preservation vesting*. Creditors can reach property vested in the owner's revocable living trust, both during the owner's lifetime and after his death.

A revocable living trust is not a vesting or legal entity separate or different from the owner, such as a partnership, limited liability company (LLC) or corporate form of ownership. [Calif. Probate Code §18200]

## LIVING TRUST CONSIDERATIONS:

**PROPERTY TAX REASSESSMENT:** Transfers of title to real estate by individuals into their revocable living trusts are exempt from reassessment. [Calif. Revenue and Taxation Code §62(d)]

*Editor's note — In an environment of financially strapped counties and trigger-happy assessors, the owner should get prior written approval from the assessor before conveying the property into an intervivos trust vesting.*

**DUE-ON-SALE:** A conveyance of real estate into any trust vesting triggers the due-on clause, requiring written pre-conveyance consent by lenders with due-on clauses in their trust deeds. [12 Code of Federal Regulations §591.5 (b)(1)(vi)]

*Editor's note — Federal regulations requiring lender approval on owner-occupied, one-to-four residential units* ***contradict*** *federal codes, which exempt transfers to revocable living trusts from due-on-sale enforcement. However, in the 1990s, the discrepancy was a moot issue with Brokers since due-on-sale interference by lenders is primarily an economic issue, not the legal issue it once was. When pressure on interest rates subsides, old loans will typically have a higher rate of interest than new loans, creating no incentive for lenders to call loans due or recast them on transfer of title to a living trust. [12 United States Code §1701j-3(d)(8)]*

**PROBATE AVOIDANCE:** Trust provisions limiting the right of a successor trustee or beneficiary to petition the probate court to resolve disputes are unenforceable. [**In re Estate of Parrette** (1985) 165 CA3d 157]

**TAX ASPECTS:** All tax consequences remain with the beneficial owner of the property, unaltered by the trust vesting — including income and expenses, interest, depreciation, profit and loss, §1031 and §1040 reporting, the $250,000 per person residential §121 profit exclusion, rental operating losses, etc. However, the appointment of a trustee other than the owner to operate the property establishes the trust as a separate taxable activity (but not a separate entity), and the owner will lose the personal tax benefits from the real estate. A property manager is not a trustee.

**FAMILY PARTNERSHIP:** Community assets vested in the name of a limited partnership or limited liability company (LLC), with the husband and wife solely owning the partnership as partners or the LLC as members, allow their capital ownership interests in the company to be vested in the living trust. The same vesting holds for stock in a corporation, trust certificates, bonds, and notes and trust deeds owned by the husband and wife.

**SURVIVING SPOUSE:** A qualified terminable interest in property (QTIP) conveys to the surviving spouse a *life estate* in the deceased spouse's property, without the ability by the surviving spouse to amend or revoke the deceased's distribution of the fee simple to, for example, their children. The surviving spouse must file a declaration with the Internal Revenue Service (IRS) stating the life estate is a QTIP to exempt the property from the deceased spouse's estate taxes under the marital deduction. However, the property will be included in the surviving spouse's taxable estate on death. [Internal Revenue Code §2056(b)]

The **singular advantage** of a revocable living trust is its ability to perform the same functions as a will while avoiding probate procedures. Given the onerous nature of California probate proceedings, the advantage of the alternative trust vesting is substantial, both in conveyance time and handling costs.

A trust agreement is nothing more than escrow instructions to the successor trustee to deed properties to named beneficiaries on the death of the owner. Probate is **litigation**, service of process on heirs and courtroom actions which span over a long period of time, not just a few weeks.

Consider a creditor who records an **abstract of judgment** which attaches as a lien to all real estate owned in the county by a judgment debtor. A parcel of real estate owned by the debtor is vested in his revocable inter vivos (living) trust. The parcel is subject to a first trust deed.

A second trust deed to secure a loan is later recorded on the real estate vested in the revocable living trust.

Ultimately, the first trust deed holder forecloses. The property is sold at a trustee's sale for a price in excess of the amount due on the first trust deed. The judgment creditor demands the excess sales proceeds, claiming his judgment lien naming the debtor attached to the real estate vested in the debtor's revocable living trust and is second in priority to the first trust deed, ahead of the claims of the second trust deed holder.

The second trust deed holder claims he is entitled to the excess funds since he was a good faith encumbrancer of the "trust asset," unaware of the judgment recorded against the debtor who was the true owner of the property held in trust.

Is the second trust deed holder entitled to the excess proceeds?

No! The judgment creditor is entitled to the excess proceeds. The second trust deed holder has **constructive notice** of the recorded judgment against the debtor who is the owner (beneficiary) of the real estate vested in the revocable living trust. A review of the trust agreement controlling the trustee who holds title reveals the true owner's identity. [**Bank One Texas, N.A.** v. **Pollack** (1994) 24 CA4th 973]

## Establishing the trust

Any trust created for the purpose of holding title to real estate for another person is only valid if the trust relationship with the trustee is declared in writing. [Prob C §15206]

Fortunately, only a minimal writing, called a *Declaration of Trust* or *trust agreement*, is required to establish a viable **living trust**.

The elements necessary to enter into a statutory living trust agreement include:

- the owner's declaration to establish a trust as the *trustor* (sometimes called the *settlor*) [Prob C §15201];
- identification of a *trustee* (usually the owner) to manage title to properties vested in the trustee as instructed by the trust agreement [Prob C §15200];
- actual conveyance of property (called the *corpus* or *trust property*) to the trustee [Prob C §15202]; and
- successor(s), called *beneficiaries*, to receive the trust property on the death of the owner. [Prob C §15205]

### Community property, separate trusts

A husband and wife should each establish separate trusts for their half of the community property. The other spouse should be named as successor trustee.

Although spouses can jointly deed their community property into one trust, the joint trust is substantially more complex and replete with distribution and trust management complications after the first death.

The complexities involved with spouses deeding into the same trust are comparable to the folly of attempting to use one set of escrow instructions to handle the sale/exchange of properties owned by two separate parties. Two escrows should be created.

Placing each spouse's community property interest into separate trusts incurs no financial, legal or tax disadvantages, and in no way alters the character of community property. The trust vesting is just another way to vest community property. [Calif. Family Code §761]

Thus, the trust agreement becomes a **title holding arrangement** which is not operative and has no legal, financial or tax consequences until death. [See Form 390 accompanying this chapter]

The only activity remaining to complete after entering into the trust agreement is to convey title to the property into the trust vesting, called *funding the trust*.

The owner must sign and record grant deeds conveying his real estate into the trust vesting. Otherwise, the property will remain vested in the owner on his death, and the trust will be useless since it was not funded and has nothing to further convey.

The property vested in the trust estate is listed in a property distribution schedule attached to the trust declaration, usually called *Schedule A*. [See Form 390 Schedule A accompanying this chapter]

In addition to identifying the trust real estate, **Schedule A** specifies the **successors** of the owner as beneficiaries to whom property will be distributed by grant deed.

Trust agreements should not be recorded. However, it is prudent to have the trust agreement notarized to verify the owner signed the document when the title company asks for it before issuing an insurance policy or any further conveyances.

## Amending Schedule A

An owner is able to add properties to Schedule A attached to the trust agreement at any time. To do so, the owner conveys properties to the trust and then adds a description of the properties to the list in Schedule A, naming the successors who are to receive the properties on his death.

Conversely, an owner removing properties from the trust and deleting them from Schedule A, or changing successors to a property, should redraft Schedule A in its entirety and attach the new draft to the original trust agreement after removing and destroying the old Schedule A.

## Underage successors

An owner might consider including a clause in his trust document to prohibit the distribution of trust property directly to successors under a certain age.

For instance, individuals under the age of 18 can receive title to real estate, but cannot execute a valid contract or conveyance relating to disposition or encumbering the real estate. [Fam C §§6500, 6701(b)]

Thus, if real estate in a trust is conveyed to an underage successor on the owner's death, a **guardian** will have to be appointed by the court to manage the property. [Prob C §1514]

To prevent the underage *successor* from being subjected to a court-appointed guardian to administer the property received, the owner can simply require the trustee (or someone else) to retain title and manage the property until the successor reaches the age of 18.

Of course, an owner may not want the property to wind up in the possession of an 18-year-old either. Some owners prefer to prevent distribution of property to their children until the children reach a more mature age, for fear a younger, less experienced successor will waste or misuse the property.

## Successor trustees to carry on

Critical to the distribution of properties on the death of an owner is:

- the naming of *successor trustees* in the declaration of trust agreement; and
- the preparation of an exhibit (attached to the trust agreement) listing the properties that are vested in the name of the trustee, followed by the name(s) of the individual(s) who are to receive the properties on the owner's death.

Variations on the distribution of the owner's property exist, such as having a list of beneficiaries who will "share and share alike" all the properties vested in the name of the trustee; or selling all the assets vested in the trustee and distributing the net proceeds of the sale to the named beneficiaries based on the percentage given each of them in the trust agreement, etc.

The variations are limited only by the simplicity or complexity sought by the owner, including the establishment by a provision in the living trust agreement for a management trust to own and operate the properties and distribute the income for a period of time after the owner's death.

A transfer of community assets, such as the disbursement of cash savings and borrowing funds to purchase a property or vest the property in the "[name of the trustee] for The [_____] Family Trust," does not alter the **community asset nature** of the property.

The trust vesting, like a joint tenancy vesting, has no effect on the nature of the property, whether the property is transferred into the trust or transferred out of the trust. It remains community property at all times since it was acquired or transmuted to community property during the marriage. [Fam C §761]

Additionally, the vesting of community property in a revocable inter vivos (living) trust avoids any conflicting attempts at distribution under a will or by intestate succession should a will not exist. The trust agreement provisions control the distribution of properties **vested in the name** of the trustee on the death of the owner. [Prob C §13504]

Taxwise, a living trust offers no ability to obtain greater or lesser **tax results** than can be attained under a will. Thus, the revocable inter vivos trust is a complete substitute for a will for those assets vested in

# DECLARATION OF REVOCABLE LIVING TRUST

**DATE:**_____________, 20______, at________________________________________________________, California.

_________________________________________________________________________ (TRUSTOR and TRUSTEE)

holds in trust the property listed in Schedule A, which constitutes the Trust Estate to be administered and distributed to the Beneficiaries listed in Schedule A.

This Trust is entitled The ______________________________________________________________ Family Trust.

**1.** Until the Trust Estate is distributed to the Beneficiaries on the Trustor's death, all income and profits from the Trust Estate shall be received by the Trustor.

1.1 Trustor retains the right to the use and occupancy of property vested in this Trust.

**2.** Trustee shall receive no compensation for distributing property out of the Trust Estate.

2.1 No bond shall be required of any Trustee.

**3.** Upon the Trustor's death, __________________________________________ shall become Trustee of this Trust.

3.1 Should the Trustee no longer be able or willing to act as Trustee, then ____________________________ shall become Trustee of this Trust.

3.2 Any Trustee is empowered to appoint one or more successor Trustees.

**4.** Upon Trustor's death, the Trustee shall distribute all property in the Trust Estate to the Beneficiaries as set forth in Schedule A.

4.1 If any Beneficiary is under the age of ______ on Trustor's death, the Trustee shall continue to hold the underage Beneficiary's portion of the Trust estate in trust, and administer the property in the best interest of the Beneficiary until the Beneficiary reaches such age, when the Trustee shall distribute to the Beneficiary.

4.2 Trustee shall receive as compensation ______% of the gross operating income while administering the Trust Estate for an underage Beneficiary.

**5.** Any property in the Trust estate not designated for distribution in Schedule A shall be distributed to _____________________________________________________________________________________.

**6.** Should any Beneficiary(ies) of the Trust predecease the Trustor, the deceased Beneficiary's share shall be distributed to _______________________________________________________________________.

**7.** The Trust shall be governed by the laws of the State of California.

Executed on _____________, 20______, at ________________________________________________, California.

______________________________________________
Trustor/Trustee's signature

STATE OF CALIFORNIA )
COUNTY OF____________________________________________)
On ____________________________________________ before me,
____________________________________________
*(name of notary public)*
personally appeared ____________________________________________
____________________________________________,
*(name of principal)*
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature: ____________________________________________
*(Signature of notary public)*

*(This area for official notarial seal)*

## "Schedule A"

**for the**
**________________________________________ Family Trust**

| Property | Name of Beneficiary(ies) | Percentage of interest to each beneficiary |
|---|---|---|
| 1. ________________ | a)________________ | ______ |
| | b)________________ | ______ |
| 2. ________________ | a)________________ | ______ |
| | b)________________ | ______ |
| 3. ________________ | a)________________ | ______ |
| | b)________________ | ______ |
| 4. ________________ | a)________________ | ______ |
| | b)________________ | ______ |
| 5. ________________ | a)________________ | ______ |
| | b)________________ | ______ |
| 6. ________________ | a)________________ | ______ |
| | b)________________ | ______ |
| 7. ________________ | a)________________ | ______ |
| | b)________________ | ______ |
| 8. ________________ | a)________________ | ______ |
| | b)________________ | ______ |
| 9. ________________ | a)________________ | ______ |
| | b)________________ | ______ |
| 10. ________________ | a)________________ | ______ |
| | b)________________ | ______ |

Initials:________ Date:_____/_____/_____

 

the trust at the time of the owner's death. A will controls the distribution of assets vested in the name of the owner at the time of his death.

Additionally, if the spouse of the deceased is the successor, and the property is a community property asset, the surviving spouse receives the entire property with a fully stepped up *cost basis* to the property's market value on the death of the spouse.

The surviving spouse receives a fully stepped up **cost basis** whether the property is vested in a living trust, as husband and wife as joint tenants, or as husband and wife under either community property vesting. [Internal Revenue Code §1014(b)(6); Revenue Ruling 87-98]

## Trust entities and trust relationships

Relationships in real estate transactions frequently include an agency relationship which rises to the level of a *trust relationship*. A **trust relationship** imposes a **duty** on the agent who holds title, or who is to deliver the property *held in trust* to others, and requires the agent to follow instructions given to him by the principal who owns the property. Real estate brokers, escrow companies, title companies, banks operating a trust business and attorneys are commonly employed by principals to act as their agents, subject to the duties of a trust relationship which is imposed while the agent holds title to or manages property owned by the principal.

A *trust company* is any corporation or bank which is authorized to engage in the activities of a trust business. A *trust business* exists when a person acts as an executor, administrator, guardian or conservator of estates, or as assignee, receiver, depositary or trustee by the appointment of the court or for any purpose permitted by law. [Calif. Financial Code §106]

A **trust business** in California has a distinctly different relationship with the public than the relationship established by the activities of a *business trust.*

**Business trusts**, frequently called a *Massachusetts trust*, are engaged in general business, not in the trust business. The relationships created under a business trust arrangement do not include the trust relationship between a principal (beneficiary) and his agent (trustee).

A business trust is an entity which cannot be established under California law. A scheme does not exist for the creation of a business trust in California. Thus, a **business trust** can only be established in states with a scheme for creating a business trust entity.

When a business trust is created in another state, it can neither operate in California nor buy, sell, lease or operate real estate located in California on behalf of the entity or anyone else without first qualifying as a corporation under the California Corporate Securities Act. Business trusts are considered *foreign corporations*. [Calif. Corporations Code §§170, 171]

As **foreign corporations**, business trusts must register with the Department of Corporations and file corporate income tax returns with the Franchise Tax Board (FTB), since they will be conducting business within the state of California by owning and operating real estate assets. [Corp C §191; Calif. Revenue and Taxation Code §23038(b)(2)(B)]

Thus, a business trust, as a foreign corporation once it enters into activities in California, must **qualify** with a state agency before:

- conducting any business [Fin C §107];
- accepting money from investors in exchange for share ownership in the trust entity; or

- conducting any other lawful business in California.

The trustee of a business trust holds title to real estate in his name (as trustee for the named business trust), and **controls the operation** of the property. The trustee is also a principal himself, and is personally liable for all debts/obligations incurred by the business trust, as though he were a general partner in a limited partnership. [**Goldwater** v. **Oltman** (1930) 210 C 408]

Further, the business trust itself is liable for obligations incurred on its behalf in the management of the real estate vested in the trustee. Also, the assets of the business trust are directly liable for any *torts* of the trustee, such as failure to properly maintain the security of tenants or the condition of the property which causes injury to others. [**Alphonzo E. Bell Corporation** v. **Bell View Oil Syndicate** (1941) 46 CA2d 684]

If the beneficiaries are authorized to exercise ultimate control over the trustee's ability to buy, sell, refinance, own or operate the property, including the trustee's selection of successor trustees, the beneficiaries will be personally liable for the debts incurred by the trustee.

Accordingly, the trustee is then **not personally liable** since he has been reduced in his powers to a mere **agent** acting on behalf of the beneficiaries. Thus, the association between the trustee and the beneficiaries is not that of a business trust at all. It is a principal-agent relationship under a management contract. [**Bernesen** v. **Fish** (1933) 135 CA 588]

### Real estate investment trusts

One trust entity, called a real estate investment trust (REIT), is authorized to be created under California law, but only if it has been:

- formed as a REIT under the Internal Revenue Code and does business under the code; and
- qualified by the Department of Corporations. [Corp C §23000]

The beneficiaries who invest in this real estate ownership entity are called *shareowners*. The **shareowners** hold transferable shares which are sold publicly. As individuals, the shareowners are not liable for the debts/obligations of the REIT. The REIT is managed by officers called *trustees* who also are not liable for the debts and obligations of the REIT.

# Chapter 33 Tenants in common as a vesting

*This chapter illustrates why a limited liability company form of vesting should be used by co-owners instead of holding title as tenants in common.*

## We cooperate in California

A group of investors acquire income-producing property located in California. Title is taken as **tenants in common**, naming each investor and stating his percentage or fractional share of *undivided ownership* in the property.

The property is occupied by tenants under short-term leases and periodic rental agreements that provide for the landlord to care for and maintain the premises.

The co-owners orally agree:

- to divide annual operating income (or losses) and resale profits pro rata based on their percentage of ownership;
- to hire the broker who organized the group to manage the property with authority to locate tenants, enter into short-term lease and rental agreements, collect rents, contract for the repair, maintenance, utilities and security to be provided by the landlord under the lease agreements, pay operating expenses and mortgage payments and distribute spendable income to the co-owners quarterly;
- to grant each other a right of first refusal on a resale of their fractional TIC interest; and
- to grant the syndicator the option to purchase the property at its fair market value.

Are the co-owners conducting themselves as partners under California partnership law despite the tenancy-in-common vesting placing each co-owner on title?

Yes! Co-owners of California real estate vested as tenants in common, when engaged in the business of **jointly operating** the property on terms calling for them to **share income and profits**, are conducting themselves as partners. Thus, they are considered *agents of one another*, charged as a fiduciary with the duty **to cooperate in the ownership** of the property. [Calif. Corporations Code §§16202(a), 16202(c)(3)]

A tenancy-in-common vesting does not control the **possessory rights** of the co-owners when the co-ownership in fact constitutes a state law partnership. For example, a partner may use or possess partnership property only on behalf of the partnership, while a tenant-in-common co-owner (at common law) may use, possess or lease the property himself, without regard to any other co-owner. [Corp C §16401(g)]

Further, tenant-in-common co-owners who conduct themselves as *joint operators* of a property, such as occurs with a rental property, are not co-owners of the real estate. They are partners who co-own their partnership. Thus, the partnership owns the property without concern for the type of vesting the group of investors has chosen.

As a *partner*, the vested co-owner does not hold a right to an interest in the property that he can independently possess or separately transfer by leasing the property to a tenant without concern for the other co-owners.

The only *transferable interest* the tenant-in-common owns is his **fractional interest in the partnership**. The partnership interest entitles him to share profits and receive distributions. Thus, the co-owner's fractional interest, vested as a tenant-in-common interest, is no more than a **personal property** share of ownership in a California partnership. [Corp C §16502]

## Trustees for one another, by law

Although title to an income-producing property held by co-owners for profit is vested in the names of all the co-owners, each co-owner actually **holds title as a trustee** on behalf of all the tenant-in-common co-owners, collectively called a *partnership*. [Calif. Civil Code §682; Corp C §16404(b)(1)]

As co-owners and operators of a rental property, they have formed a partnership, holding title in the most troublesome of all California co-ownership vestings: tenants in common, a TIC.

Thus, the conveyance of a co-owner's TIC interest to another person conveys nothing more than the co-owner's interest in the partnership's *equitable ownership* of the property. The partnership's title to the property is **held in trust**, in the name of each co-owner for the benefit of all co-owners.

## The defining acts of partners

Prior to California's 1949 enactment creating *tenancies in partnership*, TICs that owned rental property requiring centralized management did not constitute a partnership. No *agency relationship* existed between tenant-in-common co-owners before 1949 to protect the common interests of the co-owners to share profits. [**Johnston** v. **Kitchin** (1928) 203 C 766]

Since 1949, a California partnership exists when two or more investors join together to carry on a business for income and profit in California. A California business includes every trade, occupation or profession. [Corp C §16101(1)]

While landlording is not a trade or business category activity for federal income tax purposes (since the property is a passive rental operation or a portfolio asset), landlording by a syndicated group is an occupation under California partnership law. A co-ownership is a California partnership if the co-owners are involved in **sharing earnings and profits** from rental operations, refinancing and resale of the property they own. [Corp C §§16202(a), 16202(c)(3)]

Also, the receipt of income (from operations) and profits (from a sale) by co-owners from their joint investment is considered evidence of a California partnership, unless the earnings are received by a co-owner in payment:

- of an installment note, including one given in consideration for the sale of goodwill or property;
- for wages or rent due the co-owner;
- on an annuity to a surviving spouse, representative or a deceased co-owner; or
- as interest on a loan. [Corp C §16202(c)(3)]

## The tenancy-in-common partnership

With a tenancy-in-common vesting, the sharing of income and profits earned by each co-owner's **separate use** of the property — such as occurs with the extraction of minerals from the property by each co-owner for their own separate use — does not in itself create a California partnership. It takes more than the sharing of use and possession by co-owners to constitute conduct on the level of a partnership. [Corp C §16202(c)(1)]

It is the **interaction** and **coordinated conduct** of the co-owners while directly or indirectly managing or operating the investment that determines whether a state law partnership relationship exists between them. Once the conduct of co-owners in a coordinated ongoing operation of the property constitutes a **joint and mutually beneficial activity**, an agency relationship exists between the co-owners.

With the agency relationship comes *fiduciary duties* owed to partners, which obligates each prospective or actual co-owner to **act in the best interest** of the group, not to act independently on the investment opportunity before them. [Corp C §16404; **Leff** v. **Gunter** (1983) 33 C3d 508]

Thus, co-owners of rental property who are vested as tenants in common and who **act collectively** to manage the property or authorize a property manager to operate the property on their behalf, hold ownership to the real estate under what has been best entitled a *tenancy in partnership*. Each co-owner is a tenant in partnership with all other co-owners.

By the sharing of income among co-owners who are vested as tenants in common, a **tenancy-in-common partnership** is established. Each co-owner is subjected to the rights and obligations of a partner, such as:

- the duty to hold title to the real estate as a trustee for the benefit of the partnership [Corp C §16404(a)(1)];
- the right of each co-owner to use and possess the real estate — but only for group purposes [Corp C §16401(g)];
- the right to use and possess the real estate is nontransferable unless all co-owners **collectively transfer** the partnership's right to possession of the property [Corp C §§16203, 16501]; and
- the property co-owned by the group is not subject to **attachment** or **execution** on a judgment against an individual co-owner, only on claims against the partnership. [Corp C §§16201, 16501]

Under state law, tenant-in-common co-owners hold no interest in the real estate they co-own that they can legally transfer, voluntarily or involuntarily, independent of the rights of the resulting California partnership. [Corp C §16502]

However, federal tax law for determining the tax partner status of TICs disregards state laws to the contrary. [Revenue Procedure 2002-22]

## Vesting choices

When a group of investors purchases real estate, the vestings available to properly structure their common ownership interests include taking title in the name of:

- each of the investors;
- an LLC owned by the group; or
- a partnership (general or limited) comprised of the group.

A corporate ownership and vesting of real estate is infrequently used by investors in real estate held for rental income or profits on speculation due to adverse tax consequences, whether reporting as a C or S corporation.

While the steps for forming an LLC or a partnership are clearly defined and most easily memorialized, many groups still take title to the investment property in the name of all the investors — each investor to an undivided percentage of title as a tenant in common.

The annual franchise fee to the state of California is an inhibition interfering with the selection and use of an LLC or limited partnership entity.

Although vested as tenants in common, the group will be governed by partnership law. No individual will have the rights of a tenant in common since the property requires management to oversee:

- the collection of any income;
- payment of expense and debt obligations; and
- maintenance of insurance and the condition of the property.

Regarding the co-ownership of unimproved land, management responsibilities exist even if the land is unused.

However, some investors do not feel secure in their investment unless they see their names on the grant deed. Others vest (or revest) as tenants in common with the mistaken belief they will receive tax benefits otherwise disallowed, except for §1031 tenant-in-common (TIC) arrangements.

### Hazards of investors on title

Consider an investment group of five people, including the syndicator/broker. The group invests in (residential or nonresidential) rental property. The management responsibilities are undertaken by the syndicator/broker.

The syndicator will share in the income and profits from a one-fifth co-ownership interest he receives for packaging the acquisition of property.

The group erroneously takes title to the property as tenants in common, as opposed to vesting it in the name of an LLC or a partnership formally created by the group. Each individual "holds title" to an undivided one-fifth interest in the property.

Even though vested as **tenants in common**, the rights of the individual partners are not those of tenants in common. The group is presumed to be governed by partnership law. [Corp C §§16202(a), 16204(c)]

However, due to the vesting, any number of disastrous situations can occur which will cloud title to the property and put the investment at risk.

For example, one of the co-owners files a **bankruptcy petition**. The bankrupt co-owner's one-fifth interest in the title to the property is then placed in the hands of a trustee before the bankruptcy court. Title to the whole property is clouded by the bankruptcy filing of a vested co-owner since the court can sell the entire property.

Yet, if the group entered into a co-owner "buyout" agreement, the bankruptcy filing allows the other co-owners to purchase the bankrupt co-owner's interest and eliminate the adverse effect on title. The bankrupt partner is typically reimbursed for his capital contribution, less any sums received. However, the uncertainties and complications associated with court proceedings would still exist.

A formal LLC operating agreement or partnership agreement and an LLC or a partnership vesting avoids interference with title by a co-owner and his creditors. The property is owned and operated by an entity, independent of the co-owner's problems.

Consider the co-owner who finds himself in debt for reasons having nothing to do with the investment property. The co-owner's creditor attaches or liens his vested tenant-in-common interest in the property, clouding the title.

Due to the tenants-in-common vesting, a creditor's only concern is that the co-owner owns a recorded interest in the property which is attached by the creditor's recorded **abstract of judgment**.

Had title to the real estate been vested in the name of an LLC or partnership, the creditor of the indebted co-owner could not have liened the real estate itself, but only attached the co-owner's interest in the LLC or partnership by way of a court issued *charging order*. [**North Coast Business Park** v. **Superior Court** (1984) 158 CA3d 858]

Suppose one of the co-owners vested as a tenant in common dies. The right of survivorship does not exist among the tenants in common. Thus, the remaining co-owners must look to the will of the **deceased co-owner** (or inter vivos trust, if vested) for a determination as to who will be taking title to the co-owner's interest. The transfer will be accomplished by court approval in probate naming a successor to the co-tenancy interest, or by a trustee under a living trust if the deceased's interest was vested in the trustee.

Any successor to the interest of the **deceased co-owner** will be a *non-voting partner* until he is accepted by the group as a member. The successor will not possess any rights as a partner other than the right to a pro rata share of any income/profit distributed on the investment — even though the successor holds title as a tenant in common. [Corp C §16503]

Consider the co-owner vested as a tenant in common who refuses to convey his one-fifth interest when the other co-owners decide to sell, encumber or lease the property. Under the tenants-in-common vesting, *all* the co-owners must sign the grant deed or trust deed in order to convey or encumber the entire property. [Corp C §16302(a)(3)]

One co-owner's **refusal to convey** gives him the potential for establishing anarchy within the group and blackmailing the co-owners — the co-owner may demand more than his fair share of the proceeds for his voluntary cooperation. The tenants-in-common vesting has given each co-owner veto power over the majority, resulting in the loss of control over the investment — even if a tenants-in-common agreement for voting and buy out exists.

Situations like these are eliminated by keeping investors off title and organized in an LLC or a partnership form of business entity.

As an LLC or formal partnership, the co-owners are not vested with any ownership interest in the real estate. Their ownership interest is a percentage interest as a co-owner of the LLC or partnership. Each co-owner's interest in the LLC or partnership is personal property under state law, comparable to a stockholder's interest in a corporation. [Corp C §16502]

A creditor can only attach a co-owner's ownership interest in the LLC or partnership, not the real estate owned by the LLC or partnership. [Corp C §16504**; Wardley Development Inc.** v. **Superior Court** (1989) 213 CA3d 391]

## A tax partnership vs. a California partnership

The **coordinated conduct** of co-owners in the exercise of *ownership rights* to operate the investment real estate they co-own, is viewed differently under federal income tax law than under California partnership law.

Basically, if co-owners **share** the income, profit and losses generated by a joint investment in real estate and operate under an unincorporated ownership arrangement, California partnership law, which broadly defines a partnership, classifies the profit-sharing group as a partnership.

Thus, California imposes *agency obligations* on each co-owner to act in concert for the mutual benefit of the group from the first moment of discussions about a syndicated investment. As a result, anarchy within the group of co-owners is legally avoided as public policy in California.

Conversely, federal tax law places emphasis on tenant-in-common (TIC) law to establish co-owner rights. TIC ownership does not rise to tax partner status unless the co-owners are operating as either:

- a declared partnership;
- an LLC; or
- a cooperating TIC.

To avoid federal tax partnership status, each co-owner vested as a tenant-in-common must have the unrestricted common law right to independently *alienate* his fractional interest without the prior consent of other co-owners. Further, each co-owner must also have the unrestricted right to independently block any *alienation* of the entire property co-owned by the group.

**Alienation** of the entire property refers to its sale, further encumbrance or lease for a period exceeding one year.

Taxwise, the ownership of a TIC interest that retains its common law right of alienation in real estate is viewed as being the ownership of a fractional interest in the real estate itself. Thus, the tenant-in-common is not the owner of an interest in a partnership, but actually owns the property.

Further, TIC co-ownership arrangements may provide for **cooperation among the co-owners** in the ongoing management and operation of the property. **Operating the property** by *centralized management* does not violate the requirement of unanimous approval for the alienation of property. Thus, the alienation rights inherent in ownership are distinguished from the day-to-day operations of the property.

An understanding of the distinctions between federal tax law, which defines §1031 property investments as excluding fractional interests held by *tax partners*, and California's partnership law, which controls joint ventures and profit sharing ownerships, is helpful to all individuals involved in investment groups, such as:

- **syndicators** structuring the ownership for acquisition of property by an investment group they are forming;
- **investors** acquiring or withdrawing a fractional interest from a syndicated real estate investment; and
- **brokers** (or other advisors) representing a person who is buying into or withdrawing from a real estate syndicated investment.

Knowing the parameters for activities that establish a partner under California partnership law versus activities that establish a tax partnership for federal income tax reporting avoids unintended and unexpected results under either set of laws, or worse, the loss of a transaction because of insufficient knowledge.

## A tax partner's profits disqualified

The penalty for a tenant-in-common co-owner who is federally classified as a *tax partner* in the ownership of either the property sold or the property acquired in a §1031 reinvestment plan, is the loss of the entire *§1031 tax exemption* for profit taken on the property sold.

Thus, the arrangements or activities a co-owner, other co-owners, a property manager, syndicator or lender agree to between themselves, which would make a co-owner a tax partner, are or may become of great concern to investors in syndicated real estate investments programs.

When a co-owner of investment real estate is classified by the Internal Revenue Service (IRS) as a **partner**, the real estate is considered to be owned by a *tax partnership*. Classified as a partner, the co-owner's ownership interest is that of a share in a partnership and the share **does not qualify** as **§1031 property.**

Thus, an investor with after-tax cash he has accumulated or §1031 money to reinvest, who makes a *capital contribution* to a group being formed to jointly own and operate an income-producing parcel of real estate, must be assured no co-owner is sharing in any income from tenants other than rent. Co-owners who occasionally provide tenants with business or professional services, such as linen service, maid service, meals, etc., for a fee separate from rent, or share in the income received by others providing services to tenants that go beyond the **customary services** required under a lease, establish tax partner status.

# Chapter 34 The right of survivorship among co-owners

*This chapter distinguishes the joint tenancy and community property with right of survivorship vestings for the co-ownership of real estate, and explains their creation and use as well as severance of the vesting and termination of the right of survivorship.*

### Vesting reflects estate planning

A husband and wife, with the assistance of their broker, locate real estate they intend to purchase. They will use monies accumulated during their marriage and the net proceeds from a new purchase-assist loan to pay the purchase price.

The broker, as part of his due diligence on any property acquisition, asks the couple how they want to take title to the property on the close of escrow. The broker determines the couple would like the property to be vested in both of their names, as husband and wife, with the right of survivorship. On the death of a spouse, the couple wants the surviving spouse to automatically become the sole owner of the property and entirely avoid probate procedures.

The couple is not interested in vesting title under a *revocable inter vivos (living) trust* agreement which would also avoid probate.

The broker recognizes the community property aspect of their funds and recommends they take title in their names, such as "husband and wife as community property with right of survivorship," rather than "husband and wife as joint tenants." However, the broker explains the two vestings are identical for conveyancing since:

- both vestings can be *severed* before death to provide for an alternative distribution of each spouse's ownership interest to others by will or a trust agreement; and
- on death the title is cleared of the deceased spouse's interest by the surviving spouse recording an *affidavit* declaring the death of the decedent and attaching a certificate of death. [Calif. Civil Code §682.1(a); Calif. Probate Code §210; see Form 460 accompanying this chapter; see **first tuesday** Form 461]

Mindful of the **tax consequences** for the surviving spouse, the broker recommends the couple vest title to the property as "community property with right of survivorship." Like the tax consequences of a joint tenancy vesting, the surviving spouse would be assured a fully **stepped-up cost basis** for the community property. [See Chapter 33]

In this example, the broker's advice to vest the community property as "community property with right of survivorship" satisfies the couple's estate planning needs for holding title. The property acquisition is made during the marriage, and thus is considered **community property** even if the couple vested the property in their names as joint tenants.

Additionally, the couple simply intends to avoid probate procedures and administration costs on the death of a spouse. Either right of survivorship vesting avoids enforcement of any contrary provisions in the will of the deceased since no interest remains to be transferred after death.

Thus, for the surviving spouse, a "community property vesting with right of survivorship" is superior to a simple community property vesting — even though a community property vesting (without the right of survivorship) also transfers the property to the surviving spouse if the deceased dies *intestate* (with no will) or *testate* (with a will) stating the surviving spouse takes the property.

On a simple community property vesting, if no one contests the surviving spouse's right to become the sole owner of the deceased spouse's interest in the property, the surviving spouse must wait 40 days following the death before the property can be sold, leased or encumbered. After 40 days, an affidavit by the surviving spouse is recorded to clear title by declaring the death and attaching a death certificate. [Prob C §13540; see **first tuesday** Form 461]

A joint tenancy recommendation by the broker would produce the same results during ownership (transferability) and on death (taxes) as would the community property vesting with right of survivorship. Additionally, joint tenancy allows for avoidance of some **community debts** during the marriage and on death. This avoidance of debts incurred solely by one spouse is not available under either community property vesting. [CC §682.1]

### Creating a joint tenancy

Although most *joint tenancies* are created between a husband and wife, a joint tenancy can exist between non-married persons. Conversely, community property vestings are only available to a husband and wife.

Additionally, the number of joint tenants is not limited to two, as is a married couple's ownership of community property interests. Any number of co-owners can, under one deed, take title to real estate as joint tenants as long as they possess **equal ownership interests**.

Traditionally, the creation of a joint tenancy requires the conveyance of *four unities*:

1. *unity of title*, meaning the joint tenants take title to the real estate through the **same instrument**, such as a grant deed;
2. *unity of time*, meaning the joint tenants receive their interest in title at the **same time**;

## Married couple: wording the grant deed vesting

**Joint tenancy:** *John Doe and Jane Doe, husband and wife as joint tenants.*

**Community property:** *John Doe and Jane Doe, husband and wife as community property with right of survivorship.*

**Community property:** *John Doe and Jane Doe, husband and wife as community property.*

**Tenants in common:** *John Doe, a married man as to an undivided one-half interest, and Jane Doe, a married woman as to an undivided one-half interest, as tenants in common.*

**Separate property of one spouse:** *John Doe, a married man as his separate property.*

3. *unity of interest*, meaning the joint tenants own **equal shares** in the ownership of the property; and
4. *unity of possession*, meaning each joint tenant has the **right to possess** the entire property. [**Swartzbaugh** v. **Sampson** (1936) 11 CA2d 451]

Today, a joint tenancy vesting is only loosely based on these four ancient unities. For example, a joint tenancy is currently defined as ownership by two or more persons **in equal shares**. Thus, the joint tenancy co-ownership incorporates the **unity of interest** into its statutory definition. [CC §683]

Similarly, a joint tenancy must be created by a **single transfer** to all the co-owners who are to become joint tenants. Thus, the historic **unity of title** (same deed) and **unity of time** (simultaneous transfers) required under common law have been retained in one event, typically being the recording of the conveyance transferring title to the joint tenants.

A joint tenancy ownership in real estate may be created by any of the following transfers, each being a single conveyance to all joint tenants, if the conveyance states the co-owners take title "as joint tenants":

- a transfer by grant deed, quitclaim deed or assignment, from an owner of the fee, leasehold or life estate, to himself and others;
- a transfer from co-owners vested as tenants in common to themselves; or
- a transfer from a husband and wife holding title as community property, tenants in common or separately, to themselves. [CC §683]

For the small percentage of joint tenants who are not husband and wife, typically family members or life-long friends, a valid joint tenancy is created when all co-owners take title under the same deed as joint tenants, without stating their **fractional ownership interest** in the property. Their actual fraction of ownership, if severed or transferred to others, is a function of the number of individuals who took title as joint tenants. Five co-owners as joint tenants indicate each holds a one-fifth or 20% fractional ownership interest.

A vesting of "community property with right of survivorship" is created on the *acceptance* by a husband and wife of the deed vesting their acquisition of property. For a husband and wife to convert a vesting to community property with the right of survivorship, they merely deed out of their present vesting (as grantors) and deed the property back to themselves in their names as "husband and wife as community property with right of survivorship" (as grantees).

No requirement exists calling for consent to the vesting beyond mere *delivery* of the deed. [CC §682.1(a)]

## A joint tenant's right of survivorship

A joint tenancy vesting adds nothing to the legal aspects of the ownership interest held in real estate by each co-owner. Whether the interests held by the co-owners are separate property or community property, a joint tenancy vesting neither enlarges nor reduces the nature of the ownership interest.

However, the **necessary incident** of a joint tenancy vesting is the *right of survivorship*, legally referred to as *jus accrescendi*. The right of survivorship is a case law doctrine which is triggered by the death of one joint tenant. Thus, the joint tenancy vesting, by the incident of its right of survivorship, becomes operative only on the death of a joint tenant, at which point the right of survivorship **extinguishes the deceased's interest** and leaves the remaining joint tenant(s) with the entire ownership interest they held

as joint tenants. The right of survivorship is a mere **expectancy** held by each co-owner, and is not a property right.

Ultimately, and on the death of all other joint tenants, the last survivor becomes the sole owner of the interest in the property originally owned by all the joint tenants.

### Vesting alone does not transmute community property

All property acquired jointly by a married couple during the marriage, no matter how vested, is **presumed** to be community property for purposes of division between them on a **dissolution** of the marriage. [Calif. Family Code §2581]

Should a couple having vested their co-ownership of property as joint tenants seek a divorce, the property is treated as community property.

Further, the community property presumption for married couples does not only come into play when a couple divorces. All property acquired by a couple or by either spouse during marriage is considered community property, unless the husband and wife clearly state their contrary intention to own their individual interests in the real estate as separate property. [Fam C §760]

Thus, real estate acquired by a married couple, or by a married individual (unless received as a gift), regardless of joint tenancy, community property, or inter vivos trust vesting, is always presumed to be community property under California law. [Fam C §761]

### The overlay of community property

Joint tenancy rights and community property rights held by married couples **overlap** in California law when community property is placed in a joint tenancy vesting. This overlap is a by-product of California legal history.

**Joint tenancy**, with its inherent right of survivorship, arises out of the English common law, and is called a *common law estate*.

**Community property**, with its implicit partnership aspect, is a creation of Spanish civil law, dating from the time when California was a Spanish colony operating under the Law of the Indies.

Older cases treated community property and joint tenancy as **mutually exclusive**, i.e., holding real estate as community property meant it could not be held in a joint tenancy vesting and retain its community property status. Thus, a *transmutation* from community property to the separate property of each the husband and wife occurred by a transfer into a joint tenancy, comparable to vesting community property in a tenancy in common vesting today. [**Tomaier** v. **Tomaier** (1944) 23 C2d 754]

However, this mutually exclusive rule, which controlled legal results by the type of vesting and not by the community nature of the ownership by a husband and wife, was eliminated in 1975.

Today, a joint tenancy vesting is used by co-owners solely to avoid probate. The joint tenancy vesting provides no other advantage to co-owners. The underlying community or separate property character of the real estate is not affected when a husband and wife vest their co-ownership as joint tenants.

For example, a husband and wife who take title as joint tenants do not by the vesting **transmute** their community property into separate property owned 50:50 by the husband and wife.

However, a joint tenancy vesting allows a husband and wife, one of whom has a problem with a creditor, to **renounce the community property presumption** and claim they intended the joint tenancy vesting to establish separate property interests for each spouse in the real estate. Thus, the community property presumption can be rebutted by either spouse, and is occasionally exercised by a husband and wife to deter creditors. [**Abbett Electric Corporation** v. **Storek** (1994) 22 CA4th 1460]

A similar result altering community property rights occurs in federal **bankruptcy** proceedings when a husband and wife hold title as joint tenants. The interest of each spouse vested as a joint tenant is treated in bankruptcy proceedings as separate property in order to attain the objective of federal bankruptcy law to free individuals of onerous debt. Thus, a spouse's one-half interest in community property vested as joint tenants is not liable under bankruptcy for debts which were incurred solely by the other spouse and not on behalf of the community. [**In re Pavich** (1996) 191 BR 838]

If the couple does not intend by the joint tenancy vesting to transmute their community property into separate property, but to take title to their community assets as joint tenants for the sole purpose of avoiding probate (which is the case in most joint tenancy vestings), the property is **presumed** to be a community asset without concern for the joint tenancy vesting.

Thus, the nature of the underlying ownership of property held by a husband and wife as joint tenants — separate or community — may be challenged by a third party, such as a creditor of one of the spouses seeking to reach community assets.

However, title companies will always apply the community property presumption when real estate is vested in a husband and wife. A title company will not insure the conveyance of an interest in the couple's property, such as a trust deed encumbrance executed by only one spouse, since the signatures of both spouses are required to convey interests or impose liens on community property. [Fam C §1102]

## Conveying community property

Both spouses must consent to the sale, lease for more than one year, or encumbrance of community real estate regardless of how it is vested. [Fam C §1102]

If one spouse, without the consent of the other, sells, leases for more than one year or encumbers community real estate, the nonconsenting spouse may either *ratify* the transaction or have it *set aside*. The nonconsenting spouse has **one year** from the recording of the nonconsented-to transaction to file an action to **set aside** the transaction.

However, if the other party to the transaction — the buyer, tenant or lender — has no notice of the marriage, actual or constructive, the transaction cannot be set aside by the nonconsenting spouse who has failed to make the community interest known. This includes any knowledge of the agent representing the buyer, tenant or lender, about the owner's marital status. [Fam C §1102(c)]

## Conveying community property as joint tenants

The ability of a married joint tenant to sell, lease or encumber his interest in the real estate depends on whether the real estate interest vested in the individual is his *separate property* or the *community property* of the individual's marriage.

When community real estate is vested in joint tenancy, both spouses' signatures are required to execute an enforceable purchase agreement or trust deed lien, or to enter into a lease agreement with a term exceeding one year. [Fam C §1102]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

*SPACE ABOVE THIS LINE FOR RECORDER'S USE*

# AFFIDAVIT OF DEATH OF JOINT TENANT

**DATE:**_____________, 20______, at________________________________________________________, California.

_____________________________________________________________________________________,

is the deceased named in the attached certified copy of Certificate of Death and the same person named as one of the joint tenants vested as owner of the following property situated in the County of ______________________________, California, described as:

APN# _____________________

I have personal knowledge of the facts in this affidavit.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date:_____________, 20______ ____________________________________________________________

(Print Name) (Signature)

Date:_____________, 20______ ____________________________________________________________

(Print Name) (Signature)

STATE OF CALIFORNIA ___________________________________)
COUNTY OF ___________________________________________)
SUBSCRIBED and SWORN to (or affirmed) before me on this __________________________ day of _____________, 20______.
personally known to me or proved to me on the basis of satisfactory evidence to be the person(s) who appeared before me.

_____________________________________________________________

Notary Name

_____________________________________________________________

Notary Signature

*(This area for official notarial seal)*

**FORM 460** 10-01 

Thus, a sale, long-term lease or encumbrance of the community property executed by only one spouse is *voidable* since the transaction may be set aside by the nonconsenting spouse.

Further, a purchase agreement for the sale of community property entered into by only one spouse may not be enforced in any part by the buyer through an action for specific performance. Thus, a purchase agreement entered into by one spouse to sell only his one-half interest in the community property is unenforceable unless consented to by the other spouse since **no interest** in community property may be conveyed, leased or encumbered without the consent of both spouses. [**Andrade Development Company** v. **Martin** (1982) 138 CA3d 330]

### Encumbering and leasing joint tenancy property

When real estate held in a joint tenancy vesting is **separate property** — as when the joint tenants are not husband and wife or when a husband and wife in writing agree their interests are separate property — each joint tenant can sell or encumber his interest in the real estate without the consent of the other joint tenants.

Additionally, when the joint tenancy in real estate represents **separate property**, a joint tenant may lease out the entire property since a lease is a transfer of possession, and each joint tenant has the right to possession of the entire property. [Swartzbaugh, *supra*]

However, consider a husband and wife who own real estate which is **community property**, holding title as joint tenants. The husband enters into an agreement to lease the property for a term over one year, which the wife does not sign.

Under the joint tenancy rule, either joint tenant alone may lease the property. However, under the community property rule (which applies to property acquired during marriage), **both spouses** must execute a long-term lease agreement with a term greater than one year.

This one-spouse leasing scenario is an example of the misunderstanding created by the overlay of community property rights when community property is placed in a joint tenancy vesting.

Although no case or statute addresses this set of leasing facts, existing case law suggests the joint tenancy vesting should be viewed as controlling, thus allowing the joint-tenant husband to lease the property without the wife's consent. Also, the doctrine of *ratification* would influence the result (in favor of the tenant) if the nonconsenting spouse knowingly enjoyed the benefits of the lease. [CC §2310]

### Severing right-of-survivorship vestings

A husband and wife are the owners of a parcel of real estate, as community property. The vesting provides for the right of survivorship under either a community property with right of survivorship vesting or a joint tenancy vesting.

However, every co-owner vested as a joint tenant or as community property with the right of survivorship has the right to *unilaterally sever* the right of survivorship. The severance by a co-owner **terminates** the right of survivorship in that co-owner's interest, whether his interest in the real estate is separate or community property.

The separate or community property nature of the co-owner's interest in the property remains the same after severing the right of survivorship from the co-owner's interest.

A co-owner **unilaterally severing** the right of survivorship in his interest is not required to first give notice or seek consent from the other co-owner(s). [**Riddle** v. **Harmon** (1980) 102 CA3d 524]

To sever the vesting, the co-owner prepares and signs a deed from himself "as a joint tenant" or "as community property with right of survivorship" back to himself. On recording the deed, the right of survivorship is severed by having merely *revested* the co-owner's interest. The deed revesting title should include a statement noting that the transfer is intended to sever the prior vesting. [CC §683.2(a)]

Alternatively, the co-owner could transfer title to himself as trustee under the co-owner's revocable inter vivos (living) trust agreement. The conveyance into the trust vesting would also sever the right of survivorship. By the conveyance, the trust vesting would also avoid the probate process while gaining control over succession of the co-owner's interest on death. As before, community property remains community property even though it is vested in the living trust of the individual husband or wife.

Further, any transfer of a joint tenant's interest in the joint tenancy property to a third party, such as from a joint tenant parent to a child, **automatically severs** the joint tenancy.

However, a deed to oneself has only recently been recognized as a valid method for severing a joint tenancy. Historically, a joint tenant intending to unilaterally sever the joint tenancy was first required to deed the property to a third-party "straw man." The transfer to a third party having severed the joint tenancy, the straw man would concurrently deed the property back to the former joint tenant, who would hold title as a tenant in common or as community property without the right of survivorship. [**Burke** v. **Stevens** (1968) 264 CA2d 30]

The need for a straw man was based on joint tenancy's origins in feudal law, and the ancient theory that a person cannot deed property to himself. The *Riddle* court discarded this archaic and cumbersome double-deeding rule. Now, a joint tenant is able to sever the joint tenancy directly rather than through an elaborate legal fiction.

*Riddle* has since been codified, giving joint tenants the statutory right to sever joint tenancies through a unilateral deed or other written declaration. [CC §683.2]

## Recording requirement for severance

Recording is necessary to terminate another joint tenant's right of survivorship. The **unilateral severance** (deed) of a joint tenant's interest must either be:

- recorded in the county where the property is located before the death of the severing joint tenant; or
- recorded within seven days after the joint tenant's death if executed and notarized within three days before the joint tenant's death. [CC §683.2(c)]

Additionally, the joint tenancy may be severed by agreement of the joint tenants. If a written agreement to sever the joint tenancy is signed by all the joint tenants, recording or notarization is not required. [CC §683.2(d)]

All the preceding rules for recording a severance deed apply fully to the severance deed of a spouse seeking to terminate the right of survivorship held under the community property vesting. [CC §682.1]

The unilateral severance of a joint tenancy terminates the right of survivorship. Without the existence of the right of survivorship, each co-owner disposes of his interest in the property on death as he wishes, such as by will or inter vivos trust, or by the severance itself.

Although the sale of a joint tenant's separate property interest in real estate severs the joint tenancy, a lease or encumbrance of the property by a joint tenant does not.

All the procedures for severing a joint tenancy are fully available for a husband or wife to sever the community property vesting which includes the right of survivorship. [CC §682.1]

### Clear title on death by affidavit

When co-ownership of property is vested as a joint tenancy, the death of a joint tenant **automatically extinguishes** the deceased joint tenant's interest in the real estate, leaving the surviving joint tenant(s) as the sole owner(s). However, the deceased joint tenant's interest in the property must be cleared from the title before the surviving joint tenant(s) will be able to sell, lease or encumber the property as the sole owner.

The new ownership interest of the surviving joint tenant(s) is documented by simply recording an *affidavit*, signed by anyone, declaring the death of a joint tenant who was a co-owner of the described real estate. [Prob C §210(a)]

The interest in the property held by the deceased spouse "as community property with right of survivorship" is extinguished by the same **affidavit** procedure used to eliminate the interest of a joint tenant, except the surviving spouse (or his representative) is the only one authorized to make the declaration. [See **first tuesday** Form 461]

The **joint tenancy affidavit**, which is a statement made under the penalty of perjury, includes:

- the name of the deceased joint tenant, sometimes called the *decedent*;
- a copy of the deceased joint tenant's death certificate;
- a description of the real estate affected by the joint tenant's death; and
- a statement the deceased is the person vested in title to the described property as a joint tenant. [See Form 460]

Once the affidavit is **notarized, recorded and indexed**, anyone conducting a title search on the property will have notice of the joint tenant's death since the deceased joint tenant is indexed as a grantor. Thus, the surviving joint tenant becomes the **sole owner** of the property due to the right of survivorship.

### Lien or lease extinguished on death

A trust deed lien or a creditor's judgment lien secured solely by a joint tenant's interest in real estate is extinguished on the death of the joint tenant. By the right of survivorship held by the surviving joint tenant(s), the ownership interest of the deceased joint tenant is **extinguished**, leaving nothing for the lien to encumber.

These rules of nonliability for surviving joint tenant(s) do not apply to the debts of a deceased spouse under the community property vestings, with or without the right of survivorship. [CC §682.1]

Consider an **unmarried couple** who hold title to a parcel of real estate as joint tenants.

A judgment creditor of one of the joint tenants seeks to execute on the judgment by foreclosing on the joint tenant's interest in the real estate.

A notice of levy is recorded and a date is set for the execution sale. However, before the date of the sale, the joint tenant who is the judgment debtor dies.

The surviving joint tenant seeks to bar (or set aside) the judgment creditor's execution sale, claiming the judgment lien only attached to the deceased joint tenant's **separate property interest** in the real estate which was extinguished on the joint tenant's death due to the right of survivorship.

The judgment creditor claims the joint tenancy was *severed* by the recording of the levy on the deceased joint tenant's interest, terminating the right of survivorship and preserving the judgment lien.

However, until the execution sale takes place, the judgment creditor only has a lien on the debtor joint tenant's interest in the property. Since a lien does not sever a joint tenancy and the joint tenant's interest **ceases to exist** on his death, the judgment creditor's lien disappears on the death of the joint tenant as well. [**Grothe** v. **Cortlandt Corporation** (1992) 11 CA4th 1313]

Similarly, a lease entered into by only one joint tenant is extinguished on the death of the joint tenant who executed the lease. [**Tenhet** v. **Boswell** (1976) 18 C3d 150]

## Death during divorce

The coexistence of joint tenancy and community property can lead to unintended results. The following unintended result will occur whether a joint tenancy vesting or a community property with right of survivorship vesting is used.

Consider a husband and wife who own a residence as joint tenants. The wife seeks a divorce, but takes no action to **sever** the joint tenancy. Before the marriage is ordered dissolved by the court, the wife dies. The husband claims the property is now his under the joint tenancy right of survivorship and sells it to a bona fide (BFP) purchaser.

The executor of the wife's estate seeks to obtain one-half of the proceeds of the sale. He claims the joint tenancy was severed when the wife filed the action to dissolve the marriage, and all property acquired by a husband and wife during the marriage is to be divided under community property principles on dissolution of the marriage, without consideration for the joint tenancy vesting. [Fam C §2581]

However, the marriage was never dissolved (severed). Without a dissolution, the joint tenancy was never severed by the court. Until the **marriage is dissolved** and the joint tenancy is **severed**, the residence remains vested in the husband and wife as joint tenants. Thus, the husband's right of survivorship to the property was not terminated and he will retain all the proceeds from the property's sale.

The wife, who was seeking a divorce, clearly did not intend for her interest in the property to pass to her husband on her death. However, the wife did not effect her intentions — as her attorney should have advised her — by immediately severing the joint tenancy. Thus, the husband's right of survivorship was not terminated by conveyance of the deed or dissolution of the marriage, and could be enforced whether the deceased's interest in the real estate was separate or community property. [**Estate of Blair** (1988) 199 CA3d 161]

The best remedy for a spouse involved in a divorce is to promptly and unilaterally sever the joint tenancy and community property with right of survivorship vestings.

## Controlling the vesting of one-half

A spouse can unilaterally sever the joint tenancy and community property with right of survivorship vestings by:

- executing and delivering a deed that conveys legal title to a third party;

- executing a deed to him or herself;
- executing a written severance of joint tenancy; or
- executing a written instrument that evidences an intent to sever. [CC §683.2(a)]

Consider a husband and wife who own a residence as joint tenants. A dissolution proceeding is filed, creating a court-ordered preliminary injunction which prohibits both spouses from transferring or disposing of any property. The husband executes and records a *declaration of severance* of joint tenancy, deeding the property to himself. The husband dies while the dissolution proceeding is pending.

The wife claims the severance is ineffective since it violates the court-ordered preliminary injunction. The administrator of the husband's estate claims the severance is effective since it did not constitute a transfer or disposition of the property.

Was the declaration of severance of joint tenancy executed by the husband prior to his death valid?

Yes! Revesting the property by deeding it to himself did not violate the preliminary injunction against transferring or disposing of the property. [**Estate of Mitchell** (1999) 76 CA4th 1378; Fam C §2040(b)(3)]

Additionally, the community property interest of a spouse who executes a deed to him or herself to sever the title and eliminate the right of survivorship remains community property. Community property cannot be transmuted to separate property without the consent of both spouses or a court order.

A **severance deed** to oneself terminating the right of survivorship is not sufficient by itself to avoid passing the property to the surviving spouse on death for community property vested as either community property with right of survivorship or in joint tenancy.

A will must also be prepared or a living trust established (and vested with title to the property) naming the person intended to receive the spouse's community property interest on death. Otherwise, since it is community property, the property will pass by *intestate succession* (without a will) to the surviving spouse as though the severance of the vesting had never occurred. [Calif. Probate Code §13500]

Consider a similar case which is identical to *Blair* in all respects, except the wife dies **after** the marriage is dissolved but **before** the property is taken out of the joint tenancy vesting. The husband claims he is entitled to the couple's residence due to the joint tenancy right of survivorship.

However, community real estate vested in the name of the husband and wife as joint tenants becomes separate property of each on the **dissolution of the marriage**, and the community ownership of the property no longer exists. Thus, the order dissolving the marriage **severs** the joint tenancy vesting and terminates the husband's right of survivorship to the wife's interest in the property. [**In re Marriage of Hilke** (1992) 4 C4th 215]

Accordingly, the (now) ex-wife's separate property interest will be distributed under the terms of her will (**testate**), or by **intestate succession** to her heirs in the absence of a will.

### Joint tenancy tax aspects

Taxwise, the main question raised for a husband and wife when the surviving spouse becomes the sole owner of what was community property, no matter how it was vested by them, is: What is the surviving spouse's **cost basis** in the property as the sole owner after the death of the other spouse?

The surviving spouse who becomes the sole owner of community real estate on the death of the other spouse receives a fully stepped-up cost basis to the property's **fair market value** (FMV) on the date of the death which terminated the community property vesting.

Thus, the surviving spouse is entitled to a fully **stepped-up cost basis** in the real estate previously owned by the community without concern for whether the property was vested as community property (with or without the right of survivorship), as joint tenants or in a revocable inter vivos (living) trust.

State law controls how marital property will be characterized for federal tax purposes. Federal law is unconcerned with the form in which title is taken to community property. [IRS Revenue Ruling 87-98]

Under California law, all property acquired by a husband and wife during marriage is community property, regardless of the vesting, if it is acquired, managed and operated as a community asset by the couple. [Fam C §760]

Thus, the real estate owned by a husband and wife (unless vested as tenants in common) is considered community property for federal income tax purposes. Accordingly, a surviving spouse entitled to the property receives a fully stepped-up cost basis to the property's FMV on the date of the other spouse's death.

However, consider a wife who becomes the sole owner of a trust deed note on the death of her husband since they held the note and trust deed as joint tenants, in an inter vivos trust or in one of the community property vestings. The trust deed note is a carryback from a sale years earlier. The note amount contains profit the couple is reporting on the installment method for tax purposes.

At the time of the husband's death, profit on the unpaid principal in the note had not yet been taxed since calculation and payment of the **tax was deferred** until principal was received on the note.

For income tax purposes, the wife seeks a fully stepped-up cost basis on the entire note to its FMV on the date of her husband's death since she became the sole owner of the note which was community property.

The Internal Revenue Service (IRS) claims the note does not qualify for a fully stepped-up cost basis. The note contains profit from a **nonexempt sale** which is being taxed as principal is received, but has not been entirely taxed prior to the husband's death.

The wife claims the note qualifies for a stepped-up cost basis since the note is a community property asset she received on her husband's death.

Does the note qualify for a fully stepped-up cost basis?

No! The carryback note held by the community and received by the wife on her husband's death does not qualify for a fully stepped-up cost basis. The note at the time of death contained profit from a sale which was reportable (recognized) and had not yet been taxed, and the tax could not be avoided by a stepped-up cost basis on death. [**Holt** v. **United States** (1997) 39 Fed. Cl. 525]

# Chapter 35 Overview of the LLC

*This chapter examines the formation and taxation of a limited liability company (LLC), and the conversion of an existing limited partnership to an LLC.*

## A limited partnership vs. the LLC

A limited liability company (LLC) is a hybrid **business entity**. It combines state law, *limited liability* advantages of a corporation with the federal income *partnership tax treatment*. [Calif. Corporations Code §§17000 et seq.; Calif. Revenue and Taxation Code §§17941 et seq.]

Like a limited partnership, the LLC itself does not pay federal **income taxes**. Instead, all reportable income, profits and losses of the LLC are **passed through** to the members for individual tax reporting. The members, as individuals, pay federal and state income tax on their share of any LLC income and profits.

The LLC is an entity comparable to a limited partnership, but without a general (liability) partner. Limited liability in an LLC extends to all members, including the manager. Conversely, the managing general partner in a limited partnership is personally liable for the partnership's debts.

The syndicator in a limited partnership sometimes seeks to limit his liability by forming a one-man corporation to act as general partner for the partnership, rather than naming himself as the general partner. A sole, corporate general partner in a limited partnership creates a liability limitation situation for the syndicator similar to the LLC, with its limited liability extended to all individual members and the manager.

Taxwise, however, a limited partnership with a sole, corporate general partner is a co-ownership structure that is more restrictive than an LLC. For instance, all partnerships with the same corporation as the sole general partner for each are taxed as corporations unless the corporate general partner owns assets with a net worth of at least 15% of the partners' contributions to all the partnerships, limited to $250,000 for total contributions up to $2,500,000. When contributions exceed $2,500,000, the net worth of the corporate general partner must be at least 10% of total contributions by partners. [Revenue Procedure 72-13]

Also, a partnership with a corporate general partner is unable to take advantage of the exemption from tax reporting for small partnerships. Partnerships with 10 or fewer partners are exempt from filing the Internal Revenue Service (IRS) 1065 return, but only if all the partners are individuals. [Internal Revenue Code §6231(a)(1)(B)]

Taxwise, the LLC also resembles an S corporation. An LLC is essentially a small corporation (because of its state law corporate liability structure) that is treated as a partnership for income tax purposes. However, an LLC has fewer restrictions imposed on the participants and their investments than in an S corporation.

For example, the shareholders in an S corporation must be individuals (or estates, organizations or trusts in limited circumstances), and an S corporation may have no more than 100 shareholders. [IRC §1361(b)]

The members of an LLC, on the other hand, can be any kind of legal entity, including individuals, corporations, partnerships and other LLCs. Also, no limit is imposed on the **number of members**. [Corp C §17001(ae)]

For real estate syndication purposes, the LLC also resembles a real estate investment trust. Real estate investment trusts (REITs) are unincorporated organizations formed for the purpose of group investment primarily in real estate. They provide limited liability for investors and pass-through of income for state and federal tax reporting. [Corp C §23000; IRC §856]

However, the REIT is not an appropriate syndication vehicle for group investments in local real estate. The LLC offers more management flexibility and the same tax results for the participants.

For example, to qualify for federal tax reporting as a real estate investment trust, the REIT must have at least 100 shareholders and 75% of the REIT's business activities must be restricted to investments in real estate, trust deed notes, cash or government securities. [IRC §856(c)(4)]

No such restrictions apply to the LLC.

Further, a REIT must always qualify its investment program with the California Department of Corporations (DOC). Conversely, an LLC only needs to qualify its investment program if a securities risk exists for its members and no exemption applies. [Corp C §23000(b)]

## Formation by filing by one

The form for filing the *articles of organization* is the LLC-1 issued by the Secretary of State, the equivalent of the LP-1 for limited partnerships. The filing fee is $70. [Calif. Government Code §12190(b); see LLC-1 accompanying this chapter]

The $70 LLC-1 fee is for documents filed by mail. The Secretary of State charges an additional $15 counter fee for any LLC documents delivered in person.

The person signing the LLC-1 does not need to be a shareholding member of the LLC. In a typical real estate investment program, the LLC-1 will be signed by the syndicator acting alone. The syndicator then typically designates himself or an entity he controls as the managing member.

The LLC-1, when filed with the Secretary of State along with the $70 fee, establishes the LLC as a legal entity in the state of California. The filing provides limited liability for its members and manager. No further recording with the county is necessary. However, a certified copy of an LLC-1 and any other addenda or documents is typically recorded with the county recorder in the county where the LLC will hold to title to real estate. [Corp C §17052(f)]

When recorded, those dealing with the LLC, such as title companies, lenders, sellers, buyers, escrows, brokers and others, do not need to look any further than the LLC-1 in the county records to determine who to deal with — the manager, a group of managers or a majority in interest of members.

The LLC-1 form can be obtained from the Secretary of State's Limited Liability Company Unit, from the branch offices of the Secretary of State or downloaded from the Secretary of State's website at www.ca.ss.gov/business. [See Figure 1]

*Editor's note — Although LLC forms can be obtained from any branch office or downloaded from the Secretary of State's website, only the Limited Liability Company Unit in the Secretary of State's Sacramento office will accept LLC forms for filing*.

File #: ______________________

# State of California
## Secretary of State

### LIMITED LIABILITY COMPANY ARTICLES OF ORGANIZATION

**A $70.00 filing fee must accompany this form.**

**IMPORTANT – Read instructions before completing this form.**

This Space For Filing Use Only

**ENTITY NAME** (End the name with the words "Limited Liability Company," "Ltd. Liability Co.," or the abbreviations "LLC" or "L.L.C.")

1. NAME OF LIMITED LIABILITY COMPANY

**PURPOSE** (The following statement is required by statute and may not be altered.)

2. THE PURPOSE OF THE LIMITED LIABILITY COMPANY IS TO ENGAGE IN ANY LAWFUL ACT OR ACTIVITY FOR WHICH A LIMITED LIABILITY COMPANY MAY BE ORGANIZED UNDER THE BEVERLY-KILLEA LIMITED LIABILITY COMPANY ACT.

**INITIAL AGENT FOR SERVICE OF PROCESS** (If the agent is an individual, the agent must reside in California and both Items 3 and 4 must be completed. If the agent is a corporation, the agent must have on file with the California Secretary of State a certificate pursuant to Corporations Code section 1505 and Item 3 must be completed (leave Item 4 blank).

3. NAME OF INITIAL AGENT FOR SERVICE OF PROCESS

4. IF AN INDIVIDUAL, ADDRESS OF INITIAL AGENT FOR SERVICE OF PROCESS IN CALIFORNIA | CITY | STATE | ZIP CODE

STATE: CA

**MANAGEMENT** (Check only one)

5. THE LIMITED LIABILITY COMPANY WILL BE MANAGED BY:

- ☐ ONE MANAGER
- ☐ MORE THAN ONE MANAGER
- ☐ ALL LIMITED LIABILITY COMPANY MEMBER(S)

**ADDITIONAL INFORMATION**

6. ADDITIONAL INFORMATION SET FORTH ON THE ATTACHED PAGES, IF ANY, IS INCORPORATED HEREIN BY THIS REFERENCE AND MADE A PART OF THIS CERTIFICATE.

**EXECUTION**

7. I DECLARE I AM THE PERSON WHO EXECUTED THIS INSTRUMENT, WHICH EXECUTION IS MY ACT AND DEED.

______________________ SIGNATURE OF ORGANIZER

______________________ DATE

______________________ TYPE OR PRINT NAME OF ORGANIZER

**RETURN TO** (Enter the name and the address of the person or firm to whom a copy of the filed document should be returned.)

8. NAME

FIRM

ADDRESS

CITY/STATE/ZIP

LLC-1 (REV 03/2005) APPROVED BY SECRETARY OF STATE

The LLC-1 is a very limited and fairly simple document, intended mainly to:

- register the LLC with the state;
- establish it as a legal entity in order to provide limited liability to all managers and members (and a minimum tax of $800 annually to the state); and
- notify the public of the individual with the authority to bind the LLC by entering into agreements on its behalf.

In an addendum to the LLC-1, the syndicator might include an *alienation-restriction provision* to assure the members that the real estate vested in the name of the LLC cannot be sold, encumbered or subjected to a long-term lease without the consent of a majority in interest of the members. The addendum serves to limit the manager's activities to the designated purpose of the LLC — to **own and operate** the real estate for the benefit of the members.

An LLC is commonly thought of as having two or more members. However, a single person can form an LLC by filing **articles of organization** with the California Secretary of State. [Corp C §17050]

### Limited liability for all

The liability limitation for members of an LLC is slightly less extensive in its protection from debts than it is for limited partners in a limited partnership. The **limited liability protection** for the members of an LLC is the same as for the shareholders in a corporation. [Corp C §17101(b)]

**Figure 1**

Offices of the Secretary of State

Office of The Secretary of State Office of the Secretary of State
Limited Liability Companies Unit . . . . . . . . . . San Diego Office
P.O Box 9442281350 Front Street, Suite 2060
Sacramento, Ca 94244-2280 . . . . . . . . San Diego, Ca 92101-3609
(916) 657-5448 (619) 525-4113

Office of the Secretary of State Office of Secretary of State
Los Angeles Office . . . . . . . . . . . . . . . . . . San Francisco Office
300 South Spring Street . . . . . . . . . . 455 Golden Gate Ave. Suite 14500
Rm. 12513 San Francisco, Ca 94102-7007
Los Angeles, Ca 90013-1233 (415) 557-8000
(213) 897-3062

Office of Secretary of State
Fresno Office
1315 Van Ness Ave, Ste 203
Fresno, Ca 93721-1729
(559) 445-6900

For example, the liability of a partner in a limited partnership is absolutely limited to the amount of their capital contribution. However, corporate shareholders — as well as members in an LLC — can be held generally liable for the debts of the corporation or LLC if it can be proven that the corporation or LLC exists solely to shield the shareholders from liability for their debts or actions.

In a limited partnership, the limited partners escape liability beyond the amount of their contributions. However, the general partner of the limited partnership is then personally liable for all partnership debts.

In a corporation or LLC, no member, officer or shareholder is generally liable for any of the entity's debts. Without personal liability for debts incurred by the LLC, an individual can use a corporate or LLC business entity to shield themselves from liability in the conduct of the investment. Such individuals carry on their personal activities behind a corporation or LLC that is merely a facade, called an *alter ego*.

A corporation, and thus an LLC, is considered an alter ego of a controlling shareholder if:

- the corporation or LLC is entirely dominated by a single individual or by a small group of shareholders or members;
- the economic interests of the corporation or LLC are indistinguishable from the interests of the shareholders or members; and
- an injustice would result from treating the shareholders' or members' acts as the acts of the corporation or LLC and not as their own. [**Stark** v. **Coker** (1942) 20 C2d 839]

Also, a corporation that is **undercapitalized** to meet its reasonably anticipated demands for cash is often considered an alter ego of the shareholders. If a corporation is not funded with a sufficient amount of capital, it will not have sufficient assets to pay off the debts it incurs in the **ordinary course** of business.

## LLC gross receipts tax declared invalid

In March, 2006, a California superior court held the gross receipts tax imposed on an LLC by the Franchise Tax Board (FTB) under Revenue and Taxation Code §17942 is unenforceable, as it is unconstitutional. The decision is on appeal and most likely will be upheld due to the failure of the code to provide for apportionment. The decision is not binding as precedent since a trial court issued the ruling.

Despite this, an LLC that paid more than $800 to the FTB with a timely filing of returns within the past four years should consider filing a claim as soon as possible for a refund of any gross receipts tax paid. The filing of the claim stops the running of the statute of limitations which would otherwise bar a tax refund. [See **first tuesday** Form 378 accompanying this chapter]

To file a claim, fax or mail the completed **first tuesday** Form 378 to the following:

Fax: (916) 845-9796

Franchise Tax Board, P.O. Box 942867, Sacramento, CA 94267-8888

More information is available at the FTB's website at www.ftb.ca.gov.

**PROTECTIVE REFUND CLAIM**

For LLC Gross Receipts Tax

**DATE:**_____________, 20______, at ______________________________________________________, California.

**1.** LLC Name:_________________________________________________________________________________

LLC Identification number issued by the Secretary of State on filing the LLC-1:____________________________

**2.** This LLC hereby makes a protective claim for a refund of taxes paid pursuant to Business & Professions Code §10238, which has been declared unconstitutional by a San Francisco Superior Court, case # CGC-05-437721.

**3.** The tax years involved in this claim include: ________________________________________________

**4.** The amount of the claim for a refund of the tax based on the LLC's gross receipts and paid with timely filings during the preceding four years (not including the annual $800 franchise tax), is as follows:

| | |
|---|---|
| 20______ | $_______________ |
| 20______ | $_______________ |
| 20______ | $_______________ |
| 20______ | $_______________ |
| for a total claim of: | $_______________ |

**The undersigned hereby makes this claim as the LLC's managing member or the representative under the attached power of attorney and is the person to be contacted by the FTB.**

Date:_____________, 20______

Name of Manager:______________________________

Signature: ____________________________________

Phone number:_________________________________

Fax number:___________________________________

Fax: (916) 845-9796

Mail: FRANCHISE TAX BOARD
P.O. Box 942867
Sacramento, CA 94267-8888



Sufficient capitalization is rarely an issue in real estate transactions since all funds needed to own the property, in the form of cash and mortgage money, must be raised before the property can be acquired.

To be undercapitalized, a corporation or LLC is then regarded as existing in name only, created to shield the shareholders or members from liability for personal debts incurred in the entity's name. [**Automotriz del Golfo de California S. A. de C. V.** v. **Resnick** (1957) 47 C2d 792]

## Taxation by the FTB, a problem

To maintain the limited liability of its members as permitted by state law, the LLC must report and pay annual taxes and fees to the state.

Every LLC must pay an annual $800 **minimum franchise tax**, a tax also imposed on corporations and limited partnerships. [Rev & T C §§17941, 23153(d)(1)]

In addition to the minimum franchise tax, an LLC with over $250,000 in annual gross income (rents) is assessed an *annual gross income fee* by the Franchise Tax Board (FTB). The fees are:

- $900 for a total gross income of $250,000 to $499,999;
- $2,500 for gross income of $500,000 to $999,999;
- $6,000 for gross income of $1,000,000 to $4,999,999; and
- $11,790 for gross income over $5 million. [Rev & T C §17942(a)]

An LLC formed solely for real estate syndication purposes that acquires income-producing property with a scheduled gross income of less than $250,000, will not be concerned with the additional tax. Thus, ownership of income property valued at roughly $1,500,000 and $2,000,000, based on the cost of operations and the gross income, would not be subject to the annual "rental tax."

### The LLC name

A syndicator selects a name for an LLC, which must end with the words "Limited Liability Company," or the initials "LLC" or "L.L.C." The words "Limited" and "Company" may be abbreviated to "Ltd." and "Co." [Corp C §17052(a)]

As a practical matter, the **name selected** for the LLC should reference the property purchased and operated by the LLC, such as the property's name or street address. The name of the LLC should **not** include the name of the manager or any of the members, in order to avoid making their ownership interests in the LLC easily traceable.

Also, the name may not include the words "bank," "insurance company," "insurer," "trust," "trustee," "incorporated," "Inc.," "corporation" or "Corp." [Corp C §17052(d)]

For example, a typical LLC name, created from the property's address, might be "Main Street Properties, a California Limited Liability Company."

An LLC name may be reserved by applying to the Secretary of State with a Name Reservation Request Form. For a fee of $10, the name is **reserved** for 60 days. An additional $10 counter fee will be charged if the form is given in person to the Secretary of State's public counter. [Corp C §17053; Gov C §12190(a); see Name Reservation Request Form]

Alternatively, a syndicator can use a private filing service to reserve the LLC name or file the LLC forms. These companies charge a fee for these services. One such company is:

Corporation Service Company 2730 Gateway Oaks Dr. Ste. 100 Sacramento, CA 95833 (800) 927-9800 http://www.incspot.com

### Preparing the LLC-1 articles

The LLC-1 articles of organization includes a space for stating whether the LLC will be managed by all members or by one or more *appointed managers*. For real estate syndication purposes, the syndicator will, in most cases, check the box stating the LLC has one manager — the syndicator himself. Thus, he alone will be able to bind the LLC to buy, sell, encumber or lease real estate.

Also, the LLC syndicator must designate an agent for the service of process on the LLC with an address in California, as is required of any statutory entity. The agent may be an individual or an entity. [Corp C §17057(b)]

For real estate syndication, the agent for service of process is usually the syndicator or his attorney.

L

# State of California
## Secretary of State

### STATEMENT OF INFORMATION
(Limited Liability Company)

**Filing Fee $20.00. If amendment, see instructions.**

**IMPORTANT — READ INSTRUCTIONS BEFORE COMPLETING THIS FORM**

1. LIMITED LIABILITY COMPANY NAME (Please do not alter if name is preprinted.)

This Space For Filing Use Only

**DUE DATE:**

**FILE NUMBER AND STATE OR PLACE OF ORGANIZATION**

| 2. SECRETARY OF STATE FILE NUMBER | 3. STATE OR PLACE OF ORGANIZATION |
|---|---|
| | |

**COMPLETE ADDRESSES FOR THE FOLLOWING** (Do not abbreviate the name of the city. Items 4 and 5 cannot be P.O. Boxes.)

| 4. STREET ADDRESS OF PRINCIPAL EXECUTIVE OFFICE | CITY AND STATE | | ZIP CODE |
|---|---|---|---|
| 5. CALIFORNIA OFFICE WHERE RECORDS ARE MAINTAINED (DOMESTIC ONLY) | CITY | STATE<br>CA | ZIP CODE |

**NAME AND COMPLETE ADDRESS OF THE CHIEF EXECUTIVE OFFICER, IF ANY**

| 6. NAME | ADDRESS | CITY AND STATE | ZIP CODE |
|---|---|---|---|
| | | | |

**NAME AND COMPLETE ADDRESS OF ANY MANAGER OR MANAGERS, OR IF NONE HAVE BEEN APPOINTED OR ELECTED, PROVIDE THE NAME AND ADDRESS OF EACH MEMBER** (Attach additional pages, if necessary.)

| 7. NAME | ADDRESS | CITY AND STATE | ZIP CODE |
|---|---|---|---|
| 8. NAME | ADDRESS | CITY AND STATE | ZIP CODE |
| 9. NAME | ADDRESS | CITY AND STATE | ZIP CODE |

**AGENT FOR SERVICE OF PROCESS** (If the agent is an individual, the agent must reside in California and Item 11 must be completed with a California address. If the agent is a corporation, the agent must have on file with the California Secretary of State a certificate pursuant to Corporations Code section 1505 and Item 11 must be left blank.)

10. NAME OF AGENT FOR SERVICE OF PROCESS

| 11. ADDRESS OF AGENT FOR SERVICE OF PROCESS IN CALIFORNIA, IF AN INDIVIDUAL | CITY | STATE<br>CA | ZIP CODE |
|---|---|---|---|

**TYPE OF BUSINESS**

12. DESCRIBE THE TYPE OF BUSINESS OF THE LIMITED LIABILITY COMPANY

13. THE INFORMATION CONTAINED HEREIN IS TRUE AND CORRECT

| TYPE OR PRINT NAME OF PERSON COMPLETING THE FORM | SIGNATURE | TITLE | DATE |
|---|---|---|---|

LLC-12 (REV 05/2009) APPROVED BY SECRETARY OF STATE

In addition to the appointed manager, the LLC's operating agreement may provide for the appointment of officers such as president, secretary, treasurer, chief executive officer (CEO), chief financial officer (CFO), chief operating officer (COO) and so on. [Corp C §17154]

The officers do not need to be members or managers of the LLC. For example, an accountant or bookkeeper who is not a member of the LLC can be hired as treasurer or the CFO.

The LLC must have an office in the state of California where it maintains its records. LLC records include the names and addresses of all members and managers, copies of the articles of organization (LLC-1) and the operating agreement, copies of state and federal tax returns, financial statements and the books and records of the current and past four fiscal years.

A true copy of business records relevant to the amount, cost and value of all property owned, claimed, possessed or controlled within the county must be made available upon the request of the county assessor. [Corp C §§17057, 17058]

The LLC-12 *Statement of Information* must first be filed **within 90 days** after filing the articles of organization for the LLC. It must state the name and address of the LLC, its manager, agent for service of process and the type of business it conducts. The statement is then filed every two years thereafter during the calendar month in which the articles of organization were first filed. A $20 filing fee is required each time the LLC-12 is filed. [Corp C §17060; Gov C §12190(k); see LLC-12, accompanying this chapter]

If the information required in the filing has not changed since the previous year, the LLC may simply file the form, stating no changes have been made. [Corp C §17060(b)]

LLCs are not currently permitted to be licensed as real estate brokers. The Limited Liability Company Act prohibits LLCs from offering professional services to others in the name of the LLC for a fee, which includes the services of accountants, attorneys, physicians and real estate brokers. Some professions may conduct business and provide services under a parallel entity called a limited liability partnership (LLP), but not real estate brokers.

However, an LLC manager who is licensed as a real estate broker may act as the real estate agent representing the LLC as its broker, and collect a brokerage fee on transactions handled on behalf of the LLC. Also, an LLC can act as a principal in any real estate-related transaction, with the same powers as a corporation, partnership or individual, to conduct any business, buy, sell, finance and lease property, sue or be sued, enter into agreements, etc. [Corp C §17003]

## FTB annual tax reporting

Limited liability companies are considered partnerships for tax reporting purposes, except for the annual California franchise tax and tax on rental income. [Rev & T C §28.5]

An LLC is required, like a partnership, to submit a state **information return** annually to the FTB. The form for filing an LLC information return is FTB Form 568. [Rev & T C §18633.5]

An LLC reporting as a partnership for federal income tax purposes is required to file a 1065 return annually with the IRS, unless the LLC qualifies for the 10-or-fewer small partnership exemption.

## Federal small partnership exemption

Although it does not pay income taxes, a partnership — including LLCs since they automatically qualify as partnerships — is required, unless exempt, to file an information return with the IRS, reporting the income and losses passed through to the partners. [IRC §6031]

The tax form for filing the LLC information return is the IRS Form 1065. The IRS 1065 return informs the IRS of the LLC's income and losses and identifies each member along with his share of the income and losses.

An LLC automatically qualifies as a partnership for federal income tax purposes. Thus, an LLC can avoid filing an IRS 1065 return if it qualifies under the *small partnership exemption*. [IRC §7701, IRS Letter Ruling 9543017]

An LLC or partnership with 10 or fewer participants, all of whom are natural persons or estates (husband and wife are treated as one), is not required to file an IRS 1065 Form. [IRC §6231(a)(1)(B)]

The IRS has imposed further restrictions beyond the number of participants for the exemption. Even if the LLC has 10 or fewer members, the IRS has ruled it is not exempt from filing a 1065 return if:

- it has significant holdings;
- it is a "tier" entity, in which a parent entity holds interests in one or more sub-entities;
- each member's interest in the capital and profits is not owned in the same proportion; or
- all items of income, deductions and credit are not allocated in proportion to the owner's percentage of membership. [Revenue Procedure 81-11]

Generally, most small investment groups do not have significant holdings and do report income and losses based on their percentage of ownership. Despite the additional restrictions imposed by the IRS, an LLC formed for real estate syndication with 10 or fewer members can avoid filing the IRS 1065 return. Each member reports his share of income, expenses, interest and depreciation in a schedule attached to his 1040 return, such as a Schedule E for rental ownership reporting.

## Converting a partnership to an LLC

Many general partners who manage existing limited partnerships will convert their limited partnerships to LLCs. A syndicator, as manager in an LLC, has a limited liability that stands in dramatic contrast to his general liability for property operations and loans as the general partner in a limited partnership.

However, the process of conversion comes at a price. Filing the necessary forms requires fees of over $200.

Despite its cost, the advantage of limited liability gained for the syndicator ultimately outweighs the fees for converting to an LLC.

## Conversion by merger

The simplest way to convert a limited partnership to an LLC is through a process called a *merger*. The LLC scheme allows a limited partnership to be merged into an LLC, which extinguishes the limited partnership. [Corp C §17550]

To complete a merger, the LLC is first created by filing an LLC-1 with the Secretary of State. Then the limited partnership is merged into the LLC by filing a **certificate of merger** form, the LLC-9. [Corp C §17552]

A merger agreement is also required, and must be approved by the limited partners. The agreement states the terms of the merger, the names of the surviving LLC and the merging partnership and the method for converting interests in the limited partnership into membership interests in the LLC. [Corp C §15678.2]

The merger agreement can simply be the operating agreement for the LLC. The syndicator can draw up an LLC operating agreement containing the same provisions as contained in the agreement for the merging limited partnership, and state in the purposes provision: "The LLC is the successor in interest to a limited partnership of the same name."

When the merger is completed by filing the LLC-9, the limited partnership ceases to exist as a separate entity, and the LLC succeeds to all the property, debts and liabilities of the "disappearing" limited partnership. No further act or documentation is required to transfer the partnership's real or personal property to the LLC. [Corp C §17554(a)]

However, if required by a title insurer, the change of ownership to the real estate can be documented by recording a copy of the LLC-9 and the LLC-1 with the county recorder of the county where the property is located.

A copy of the LLC-9, certified by the Secretary of State and recorded in the county recorder's office, serves as a notice of the transfer of property ownership to the LLC. [Corp C §1109]

Also, the limited partnership is dissolved automatically on filing the LLC-9, without having to file a certificate of dissolution (LP-3) or certificate of cancellation (LP-4). [Corp C §15678.4(c)]

The syndication program itself remains identical after the merger. The investors retain the same proportional interests, rights and obligations in the LLC as in the limited partnership as long as the LLC operating agreement is a mirror image of the limited partnership agreement.

The conversion is little more than a change in the entity's surname and the titles of co-owners of the entity. The limited partnership becomes an LLC, the limited partners become members and the general partner becomes the manager. Property operations and federal tax reporting remain the same.

The significant difference is the limited liability the former general partner gains as the syndicator of the newly-formed LLC. However, the syndicator's liability limitation does not extend to his liability for debts existing before the limited partnership was merged into the LLC. [Corp C §17554(d)]

## The drawbacks of conversion

The conversion from a limited partnership to an LLC does not qualify as a change of ownership that triggers **reassessment** of the partnership's property, as long as all the members retain the same proportional interests in the LLC as in the extinguished partnership. [Rev & T C §62(a)(2)]

However, the conversion from a limited partnership to an LLC is a transfer of the limited partnership's property that triggers the due-on-sale clause in any security device, such as a trust deed, encumbering the property. [12 United States Code §1701j-3(a)]

Although the due-on-sale clause is triggered by this technical, statutory transfer of the partnership's property to the LLC, notice to the lender is avoided if the merger documents (LLC-1 and LLC-9) are not recorded with the county recorder.

No county recording is necessary to transfer the property to the LLC, since the LLC automatically succeeds to all rights and obligations of the partnership on filing the LLC-9 with the Secretary of State. Title to the real estate, tax billings and insurance policies can remain in the partnership's name since the LLC, even though the LLC-1 is not recorded, is still the successor-in-interest to the partnership.

If the LLC-9 is not recorded, and since no grant deed to the LLC exists, nothing on record will indicate a transfer of the property has taken place.

Of course, in order to obtain title insurance for a refinance or sale of the property, the LLC-9 will have to be recorded with the county recorder. However, delaying the recording interferes with the lender's ability to discover the transfer and call the loan due until the property is actually sold.

The Secretary of State will not file the LLC-9 until a *tax clearance certificate* is obtained from the FTB, stating the limited partnership has paid all taxes for which it is liable. [Corp C §17552(e); Rev & T C §23334]

Also, an LLC is not liable for the franchise tax if its tax year is 15 days or less and it does not do business during that tax year. Thus, the creation of an LLC and the merger should occur during the last 15 days of December. [Rev & T C §17946]

## LLC-12 information statements

Within 90 days after recording an LLC-1 form with the state of California, called a *filing*, the LLC syndicator, as manager, must fill out an LLC-12 form **Statement of Information** and send it, along with a check for $20 payable to the Secretary of State, to:

Secretary of State, Statement of information Unit P.O. Box 944230 Sacramento, CA 94244-2300

Failure to file the LLC-12 within the 90-day period following the filing date of the LLC-1 results in a $250.00 penalty. The LLC-12 form is available online at www.ss.ca.gov/business. There, it can be viewed, filled out and printed from your computer for preparation prior to mailing to the state.

In addition, every two years after filing the LLC-1, an LLC-12R statement of information form must be mailed to the Secretary of State for filing, along with a payment for the $20.00 processing fee. The period for filing the LLC-12R is every two years during the month in which the LLC-1 was filed or the preceding five months. Filing the LLC-12R continues until the LLC files an LLC-4/8 form for cancellation of the LLC entity.

## Preparing the statement of information

The following **instructions** are for the preparation and use of the LLC-12 statement of information. Each instruction corresponds to the provision in the form bearing the same number.

1. **Enter** the name of the limited liability company exactly as it is recorded with the Secretary of State.
2. **Enter** the file number issued by the Secretary of State.
3. **Enter** the state under whose laws the LLC was organized.

4. **Enter** the complete street address, city and zip code of the principal executive offices of the LLC. Do not enter a P.O. Box or abbreviate the name of the city.
5. **Enter** the complete street address, city and zip code of the office in California where the LLC's physical records are maintained.
6. **Enter** the name and complete business or residential address of the chief executive officer, if one exists.
7. **Enter** the name and complete business or residential address of the manager identified in the LLC-1 articles or operating agreement.
8. **Provides** for identification of an additional, named manager.
9. **Provides** for identification of an additional, named manager.
10. **Enter** the name of the agent for service of process located in California. Typically, the manager is the agent for service of process. However, a member or an attorney who represents the LLC could be named as the agent for service.
11. **Enter** the business or residential address of the agent for service if he is an individual.
12. **Enter** a brief description of the business conducted by the LLC.
13. **Enter** the name and title of the person completing the LLC-12 form. **Enter** the date this form was prepared and **obtain** the signature of the person named.

## Cancellation of the LLC-1

Within 12 months after creating an LLC by filing the LLC-1 with the Secretary of State, a syndicator may need to or want to cancel the LLC. **Cancellation** eliminates the LLC entirely and terminates any further assessment of the annual $800 franchise tax on the entity.

Frequently, an LLC entity is formed solely to hold title to real estate for an individual who is the true owner of the property. For federal tax reporting purposes, the LLC is considered a *disregarded entity*, which does not affect the individual's personal tax handling of real estate vested in his "one-man" LLC.

The individual creates his one-man LLC by preparing, signing and filing the LLC-1. He takes on no co-owner, acts as the sole owner of the LLC, which does not report to the IRS, but does report to the California FTB and pay the annual California LLC franchise tax.

While the individual vests his property in the name of the LLC, he may want to retain the LLC vesting but cancel the entity to eliminate the annual franchise tax (and of course end the right of the LLC to sue or be sued and his right to limited liability for obligations of the LLC). Since the LLC was formed only for the purpose of vesting title to the property in the name of the LLC in lieu of vesting title in the name of the individual, the limited liability shield serves no legal consequence.

A checking account is established in the name of the LLC and will be retained. Following the cancellation of the entity, title will remain in the LLC vesting.

If the individual needs to encumber or convey the property on a refinance or sale, the LLC-1 remains of record with the county recorder, authorizing the individual to encumber or convey real estate vested in the name of the LLC, even though it, as an entity, has been formally canceled with the state of California. Conveying is different from suing someone in the name of the LLC since maintaining a lawsuit is not permitted after cancellation of the LLC-1, but the individual is unaffected by the cancellation and is able to sue in his own name.

State of California
Secretary of State

LIMITED LIABILITY COMPANY
SHORT FORM CERTIFICATE OF CANCELLATION

There is no fee for filing a Short Form Certificate of Cancellation.
IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

**FILE NUMBER**
1. Secretary of State File Number

**ENTITY NAME** (Enter the exact name of the domestic limited liability company.)
2. Name of Limited Liability Company

**REQUIRED STATEMENTS** (The following statements are required by statute and may not be altered.)

3. a) This Short Form Certificate of Cancellation is being filed within twelve (12) months from the date the Articles of Organization were filed with the Secretary of State.
   b) The limited liability company does not have any debts or other liabilities, except as provided in Item 3(c);
   c) The tax liability of the limited liability company will be satisfied on a taxes-paid basis or a person, limited liability company, or other business entity assumes the tax liability, if any, of the dissolving limited liability company as security for the issuance of a tax clearance certificate from the Franchise Tax Board and is responsible for additional taxes or fees if any, that are assessed under the Revenue and Taxation Code and become due after the date of the assumption of tax liability;
   d) The final tax return has been filed with the Franchise Tax Board, as required under Part 10.2 (commencing with Section 18401) of Division 2 of the Revenue and Taxation Code.
   e) The limited liability company has not conducted any business from the time of the filing of the Articles of Organization; and
   f) Payments received by the limited liability company for interests from investors, if any, have been returned to those investors

**ASSETS** (Check the applicable statement. Note. Only one box may be checked.)

4. ☐ The known assets of the limited liability company remaining after payment of, or adequately providing for, known debts and liabilities have been distributed to the persons entitled thereto
   ☐ The limited liability company has acquired no known assets.

**DISSOLUTION** (Check the applicable statement. Note. Only one box may be checked.)

5. ☐ A majority of the members or managers of the limited liability company named in item 2, have voted to dissolve the limited liability company The undersigned constitutes a majority of the members or a majority of the managers
   ☐ There are no members or managers The sole person or a majority of the persons who signed the Articles of Organization of the limited liability company named in item 2 has voted to dissolve the limited liability company The undersigned constitutes the sole person or a majority of the persons who signed the Articles of Organization.

**EXECUTION**

6. I declare I am the person who executed this instrument, which execution is my act and deed.

| Signature of Member, Manager or Organizer | Date | Type or Print Name of Member, Manager or Organizer |
|---|---|---|
| Signature of Member, Manager or Organizer | Date | Type or Print Name of Member, Manager or Organizer |
| Signature of Member, Manager or Organizer | Date | Type or Print Name of Member, Manager or Organizer |

**RETURN TO** (Enter the name and the address of the person or firm to whom a copy of the filed document should be returned.)

7. NAME
   FIRM
   ADDRESS
   CITY/STATE/ZIP

LLC-4/8 (EST 03/2005) APPROVED BY SECRETARY OF STATE

Occasionally, a syndicator files an LLC-1 in anticipation of acquiring a property by forming an investment group, but is unable to close escrow and take title in the name of the LLC. The syndicator may have encountered difficulty clearing contingencies and, as a result, canceled the purchase agreement and escrow instructions. It is more likely that he failed to solicit and obtain sufficient commitments from investors to fund the closing.

Either way, the LLC now exists as an entity and the LLC-12 must be filed within 90 days after filing the LLC-1 or a $250 penalty is incurred. The syndicator must pay ongoing annual $800 franchise tax as long as the LLC-1 remains uncancelled. Thus, within 12 months after filing the LLC-1, the syndicator who created an LLC and no longer needs it, can prepare and file an LLC-4/8 form to rid himself of further liability and the continued existence of the LLC as an entity. There is no charge for filing an LLC-4/8. Any filing by mail should be sent Certified Mail Return Receipt Requested.

Before filing the LLC-4/8 cancellation, a final tax return must be filed with the Franchise Tax Board. However, a return does not need to be filed with the IRS if a return has not previously been filed.

The following instructions are for the preparation and use of Form LLC-4/8 Certificate of Cancellation. Each instruction corresponds to the provision in the form bearing the same number. [See Form LLC-4/8 accompanying this chapter]

1. **Enter** the file number assigned to the LLC by the Secretary of State.
2. **Enter** the name of the LLC exactly as it is recorded with the Secretary of State.
3. **Provide** statements required by the person canceling the LLC-1 and which cannot be altered. The form cannot be used if any of the statements do not apply.
4. **Check** the appropriate box to indicate whether property or cash has been acquired by the LLC or if neither has been acquired.
5. **Check** the appropriate box to indicate whether a group of members organized under an operating agreement has voted to dissolve the LLC, or the organizer who signed the LLC-1 has decided to dissolve the LLC.
6. If an operating agreement has not been entered into and no members have been admitted into the LLC, the individual who signed the LLC-1 must sign the LLC-4/8 as the organizer. If there are members, then a majority of the members must sign.
7. **Enter** the name and address of the person to whom a copy of the filed LLC-12 is to be returned.

# Chapter 36 LLC membership buyouts

*This chapter reviews the provisions in an operating agreement for a limited liability company (LLC) which allow for the buy out of one member by others.*

## Assigning or terminating a member's interest

Consider an investor who acquires a fractional ownership interest in a limited partnership which owns real estate. Later, the partnership is *converted* to a limited liability company (LLC) to eliminate the general partner's exposure to future liabilities.

An LLC *operating agreement*, nearly identical to the prior partnership agreement, is entered into by all parties involved. Each investor's ownership interest in the limited partnership is **converted** to a *member's interest* in the LLC, and the general partner is given the title *manager*.

The investor now wants to sell his fractional **membership interest** in the LLC.

However, the LLC **operating agreement** restricts the **assignability** of a member's interest, as did the limited partnership agreement. This *restraint* on assignability exists to prevent the admission of outsiders who might later interfere with the LLC's investment objectives and operations.

The LLC's operating agreement permits a member to **sell and assign** his membership interest in the LLC if:

- the manager or another member of the LLC exercises his *right of first refusal* to buy and acquire the investor's interest;
- the other members **waive** their *right to terminate* a member's interest should it be sold without their approval; or
- a voting majority of the members in interest **consent** to the sale and assignment of the member's interest. [See Figure 1 accompanying this chapter]

The investor first offers to sell his membership interest to the manager under the **right of first refusal** given to the manager in the LLC operating agreement.

The manager declines the offer since he is forming new investment groups to amass his own future wealth and has no interest in repurchasing or marketing fractional interests held by investors in existing investment groups. The manager would rather put investors into fresh deals which add fees and participation in ownership to the manager's portfolio.

Next, the investor offers to sell his fractional interest to other members of the LLC, who also decline.

The investor locates an outside buyer who is interested in buying his membership interest.

The other members pose no objection to the investor selling and assigning his interest and agree to *waive their right* to terminate the investor's membership interest on a sale to a buyer.

However, the other members are unwilling to also approve an assignment of the investor's membership interest and accept the buyer as a *substitute member*.

## Buy-out provisions restrict assignments

By the terms of the operating agreement, a member's interest may be terminated by the remaining members if the existing member transfers his interest without the prior approval of the remaining members, unless they have *waived* their right to do so. On termination, the remaining members have the **right to buy out** the selling member's interest at what is usually an advantageous, predetermined price. [See Figure 1]

To continue with our previous example, while a waiver of termination rights allows the investor to freely dispose of his interest, the refusal of the other members to accept the investor's buyer as a member reduces the value of the investor's fractional interest.

The investor claims the limited liability company (LLC) cannot impair his right to sell and assign his fractional membership interest in the LLC to a buyer.

However, the **assignability**, and thus marketability, of a member's interest can be controlled by the LLC operating agreement. [Calif. Corporations Code §§17301, 17303]

Thus, while the investor may assign his interest to the buyer, the assignment cannot be freely made due to the restraint on a transfer agreed to in the LLC operating agreement. Even if a waiver is obtained from the other members, an assignment does not substitute the buyer as a new member.

The remaining members must **approve** of the buyer as a *substitute member* and **release** the investor from the LLC before the **right of membership** can be transferred to the buyer. [Corp C §17303]

Consent to the assignment of a membership interest by the remaining members is accomplished by a vote of a majority in interest of the members in the LLC, unless the operating agreement calls for a different voting percentage. [Corp C §17303]

Until approved as a **substitute member**, the buyer by an assignment of the investor's interest is a *non-voting member* of the LLC. [Corp C §17301]

## Assignable interests in an LLC

No member of a limited liability company (LLC) has an ownership interest in the LLC's real estate. [Corp C §17300]

Rather, a member owns a **personal property** interest as a shareholder in the LLC which owns the real estate. [Corp C §17300]

Two **assignable interests** exist in an LLC:

- the ownership interests held by members; and
- the manager's administrative interest.

All of the fractional **ownership interests** in the LLC are held by its members only. The shares of ownership are based on the value of each member's contributions to capital, be they contributions in the form of cash (by investors) or assignment of purchase rights (by syndicators).

Unlike a standard member, the **manager's position** carries with it the administrative responsibility to operate the LLC and manage the real estate acquired with the capital contributed by the members. The manager is the **administrator** who oversees the day-to-day operations.

**Figure 1** *Excerpt from **first tuesday's** LLC Operating Agreement*

5. **ASSIGNMENT OF INTEREST, SUBSTITUTED MEMBER:**

5.1 Assignment of Interest: A member may assign his membership interest to any other member at any time after he has given the manager ten (10) days notice to buy his interest on the same terms agreed upon with another member.

5.2 Invalid Assignment of Interest: All other assignment or transfer of members' interests are terminated according to the method under Section 6.

6. **TERMINATION OF MEMBERSHIP INTERESTS:**

6.2 Events Causing Termination of a Member: A member may be terminated if any of the following events occur:

a. He dies, unless survived in interest by a joint tenant;

b. He is adjudges insane or incompetent, or is committed to a mental institution;

c. He transfers his interest to a non-member under against his interest;

d. He fails to immediately remove a charging order against his interest;

e. He files for bankruptcy;

f. He voluntarily retires, withdraws or resigns as a member;

g. He is expelled by court order or by all of the remaining members; or

h. He fails to contribute capital to the limited liability company as agreed to in Section 2.1.

6.3 Notice of Termination: Service upon the member to be terminated of a written notice stating the cause for termination and the effective date of termination terminates all of his powers and his right to share in limited liability company profits as of the effective date. The effective date is 30 days after service of the notice. Each remaining member shall be served under Section 13.2 both a copy of the notice of termination and a notice of the option rights held by the remaining members under Section 7.

7. **OPTION TO PURCHASE:**

7.1 Option to Purchase Upon Termination: Upon termination of a member's interest under Section 6, the remaining members may:

a. Dissolve and liquidate the limited liability company under Section 10.1; or

b. Buy the terminated member's entire interest. Where more than one member exercises his option, those exercising shall purchase their pro rata shares as among their cumulative ownership interest.

7.2 Notice of Exercise of Option:

a. When a member dies, notice of the option shall be given to the deceased's representative within 120 days after the representative's appointment.

Additionally, the manager, like the president of a corporation, can be terminated and a new manager appointed at the will of the members. The **members govern** the LLC, like shareholders and directors of a corporation, since the members hold the voting rights over the *alienation* of the LLC's ownership interest in the real estate it owns.

Any capital interest also held by the manager of the LLC is vested in his name as a participating member with a percentage of ownership in the LLC. Thus, the contributing manager would be both the manager and a member.

The manager's individual membership share as a co-owner of the LLC typically arises out of his *assignment* to the LLC of his right to purchase the property which the LLC acquired, although he may have also contributed cash.

### Assignee's rights to participate

An **assignment** of a member's ownership interest, with or without the approval of the other members of the limited liability company (LLC), does not *dissolve* the LLC. The LLC continues to operate without concern for the assignment. [Corp C §17301(a)(2)]

While the member's economic interest in the LLC is assignable, the sale and assignment of the member's interest does not automatically entitle the buyer of the fractional interest to governing rights held by a **voting member**. [Corp C §17301(a)(2)]

Without the remaining members' waiver of their **right to terminate** the selling member's interest, the selling member's assignment may result in his interest being terminated and bought out by the manager and remaining members.

If the remaining members neither buy out the interest assigned nor consent to the assignment, the buyer of the fractional interest is only entitled to an **accounting** of the distributions of income, profit or loss the selling member would have regularly received. [Corp C §17301(a)(3)]

Additionally, without acceptance as a member by a majority vote of the remaining members in interest, the buyer acquiring a member's fractional interest is not entitled to vote or participate in the governing of the LLC or exercise the rights of a member, unless the operating agreement states otherwise. [Corp C §17301(a)(2)]

Likewise, a judgment creditor of a member can *involuntarily acquire* that member's ownership interest in the LLC through a charging order and sheriff's sale of the member's fractional interest to satisfy a debt owed by the individual member.

However, on acquiring the fractional interest of a member at a judicially ordered sale of that interest, the foreclosing judgment creditor only receives the rights of an **assignee** as a nonvoting member of the LLC. The distributions of income, profit or loss the original member would have received are all the creditor is entitled to. [Corp C §17302]

A buyer or creditor who is assigned or forecloses on a member's interest and is not approved as a member receives only the member's **economic interest** in the LLC and assumes no duty or liability to the LLC or its other members. [Corp C §17301(b)]

## Substitute member's obligations

The buyer of a member's fractional interest may be admitted as a *substitute member* by a majority vote of the remaining members as controlled by the operating agreement. When substituted, the new member takes on all the **rights and responsibilities** of the selling member, including all capital contributions assessed against that member's fractional interest. [Corp C §17303(b)]

Additionally, on approving an assignment to a **substitute member**, the remaining members must vote to amend the LLC to substitute and release the selling member from future liability to the LLC, called a *novation*. Without a release of liability, or **novation**, the selling member remains obligated to the LLC under the operating agreement he originally entered into. [Corp C §17303(c); see Form 374 accompanying this chapter]

*Editor's note — After he has left, the selling member cannot later interfere with the LLC's objectives. The selling member's withdrawal does not release him from all obligations owed to the remaining members. A* ***fiduciary*** *duty among members still remains in regard to investment opportunities and operations which are known to the released member and are of value to the LLC. [****Leff*** *v.* ***Gunter*** *(1983) 33 C3d 508]*

*The same fiduciary duty is owed to the LLC by the substitute member who becomes a voting member.*

## Documenting the transfer

An *assignment* of a withdrawing member's interest and *substitution* of the buyer as a new member are completed by:

- a written **assignment** from the withdrawing member to the buyer; and
- an **amendment** to the operating agreement by a vote of the remaining members.

With an **assignment**, the withdrawing member transfers all his right, title and interest in the limited liability company (LLC) to the buyer who is acquiring his fractional interest. [See Form 374]

If the remaining members elect to accept the buyer as a substitute member, the operating agreement is **amended** to *substitute* the new member (buyer) for the withdrawing member. [See Form 375 accompanying this chapter]

For the amendment to be effective on the substitution of a member, it must be signed by the remaining members holding the percentage of ownership interest called for in the operating agreement, usually a super-majority (e.g., 75%).

Should the operating agreement not state the percentage of ownership interest required to consent to a substitute member, then a majority in interest of the members must sign the amendment. [Corp C §17303(a)]

The LLC does not need to prepare and file an amended Certificate of Limited Liability Company (LLC-2) on the assignment of a member's interest. [See LLC-2 accompanying this chapter]

However, when admitted to the LLC as a substitute member, the substitute member's name must be added to the list of current members which is required to be kept at the LLC office maintained by the manager. [Corp C §17100(b)]

# AMENDMENT TO OPERATING AGREEMENT
of Limited Liability Company

**DATE:**_____________, 20______, at _______________________________________________________, California.

*Items left blank or unchecked are not applicable.*

**FACTS:**

This amends the operating agreement of ____________________________, a California Limited Liability Company, dated_____________, 20______, at _________________________________________________________, California, formed under a Certificate of Limited Liability Company (LLC-1) filed with the California Secretary of State on _____________, ______ as document number __________________, and recorded on _____________, ______ as document number __________________, with the county recorder of _______________________ County, California.

**AGREEMENT:**

The Operating Agreement of Limited Liability Company is amended as follows:

**1.** ____________________________________________ is substituted as the new manager in the place of ____________________________________________, who is released of all rights and obligations under the operating agreement. The new manager shall immediately file an LLC-2 Amendment to Certificate of Limited Liability Company with the Secretary of State and record the same with the office of the county recorder where the limited liability company's real estate is located.

**2.** ____________________________________________ is substituted as a new member in the place of ____________________________________________, who is released of all rights and obligations under the operating agreement. An assignment of the member's interest is attached. [**first tuesday** Form 375]

**3.** The limited liability company has acquired the ownership interest in the limited liability company held by ____________________________________________, who is released of all rights and obligations under the operating agreement. An assignment of the member's interest is attached. [**ft** Form 375]

**4.** ____________________________________________ is added to the limited liability company as an additional member for the agreed capital contribution of $__________________ payable in cash or ____________________________________________, for a percentage ownership in the limited liability company of ______%.

**5.** The members agree to contribute additional capital to the limited liability company in the amount of $_______________ as set forth in Exhibit "A" attached to this amendment.

**6.** Other ______________________________________________________________________________
______________________________________________________________________________________
______________________________________________________________________________________

**I agree to the terms of this amendment.**

| | | |
|---|---|---|
| Member | Member | Member |
| Member | Member | Member |

## Manager's assignments

The assignment of a limited liability company (LLC) manager's interest is more complex than the **assignment of a member's interest**. It is accomplished by:

- a written assignment by the manager or notice of termination by the members;
- a vote amending the operating agreement to identify the new (substituted) manger; and
- a filing with the Secretary of State and recording with the county recorder of an **amended Certificate** of Limited Liability Company (LLC-2) naming the substitute manager. [Corp C §17054(c)(2)]

The withdrawing manager's interest is assigned to a substitute manager and the operating agreement is amended by preparing the same documents used to substitute members. [See Forms 374 and 375]

Whenever a manager is substituted or removed, the LLC must notify the Secretary of State of the change by filing the LLC-2. [Corp C §17054(c)(2)]

An LLC-2 is a standardized form issued by the Secretary of State's office to amend or correct the Certificate of Limited Liability Company (LLC-1) which is on file with the Secretary of State. [See LLC-2 accompanying this chapter]

After the LLC-2 is filed with the Secretary of State, to terminate the prior manager's authority to act on behalf of the LLC the LLC-2 must be recorded in the county where the LLC's real estate is located. [Corp C §17052(f)]

## Due-on and reassessment

Two further consequences must be considered when assigning a selling member's fractional interest in a limited liability company (LLC).

First, the manager and remaining members must review each provision in the trust deeds encumbering the real estate owned by the LLC for the existence of a *due-on clause* since the buy out of a co-owner's fractional interest may trigger the lender's **right to call or recast** the terms of the loan.

If a **due-on clause** exists which contains wording relating to the transfer of fractional ownership interests in the entity vested in title, the clause would be triggered by the assignment. The remaining members must then decide whether to notify the lender of the "off-record" buy out.

Second, the remaining members must ascertain whether the assignment of the selling member's interest is classified as a **change in ownership** which would trigger *reassessment* by the county assessor and result in higher property taxes.

The transfer of 50% or less of the ownership interests held by members during the life of the LLC does not constitute a change in ownership and does not trigger reassessment of real estate vested in the name of the LLC. Thus, the transfer by members of more than 50% of the member's ownership of the LLC does trigger reassessment of the LLC's property. [Calif. Revenue and Taxation Code §64(a)]

Additionally, when a member with a minority interest in an LLC acquires enough ownership interests to hold a majority interest (more than 50%), a *change of ownership* occurs, triggering reassessment of the entire parcel of real estate owned by the LLC. [Rev & T C §64(c)(1)]

## ASSIGNMENT OF INTEREST
of Limited Liability Company

**DATE:**_____________, 20______, at________________________________________________________, California.

*Items left blank or un checked are not ap pli ca ble.*

**FACTS:**

**1.** This assignment is of a member's interest in ________________________, a California Limited Liability Company, organized under an operating agreement dated _____________, ______, at _____________________, California, and formed under a Certificate of Limited Liability Company (LLC-1)

1.1 filed with the California Secretary of State on _____________ as document number _____________, and

1.2 recorded on _____________ as document number ________________________ with the county recorder of __________________________ County, California.

**FOR VALUE RECEIVED**

**2.** I hereby sell, assign and transfer to _____________________________________________, all my rights, title and interest as a member in _____________________________________, a California Limited Liability Company,

2.1 which interest is identified as Class "______" and represents ______% of the voting ownership of the limited liability company, and is represented by the attached Certificate of Interest in Limited Liability Company (if one exists).

**3.** Assignor hearby authorizes ______________________________, as the manager of the limited liability company, to reflect this assignment on the books of the limited liability company.

**4.** This assignment is subject to any restrictions on the transfer of an ownership interest provided in the Operating Agreement of limited liability company for the limited liability company.

4.1 Any necessary notices and approval of this assignment by the limited liability company or members and any right of first refusal or option to purchase the interest assigned held by the remaining members ☐ have, or ☐ have not, been consented to or waived by them.

**5.** Assignee hereby assumes and agrees to timely perform all the assignor's obligations under the operating agreement of limited liability company.

| | |
|---|---|
| Date:_____________, 20______ | Date:_____________, 20______ |
| ______________________________<br>Assignor | ______________________________<br>Assignee |
| ______________________________<br>Assignor | ______________________________<br>Assignee |

**FORM 375** 10-01  **first tuesday**, P.O. BOX 20069, RI VERSIDE, CA 92516 (800) 794-0494

### Vesting of member is estate planning

Vesting co-owned real estate in a limited liability company (LLC) instead of as tenants in common eliminates any interference with title to the real estate on the death of an LLC member.

By filing the Certificate of Limited Liability Company (LLC-1), entering into an operating agreement to create an LLC and vesting real estate in the name of the LLC, the death of a member (co-owner) does not create chaos for the management of the real estate. This is in contrast to what occurs on the death of a co-owner when he is vested on title as a tenant in common.

The membership interest held in the LLC by a deceased member is transferred on or after death according to how he vested his ownership interest.

# State of California
## Secretary of State

## LIMITED LIABILITY COMPANY CERTIFICATE OF AMENDMENT

**A $30.00 filing fee must accompany this form.**

**IMPORTANT – Read instructions before completing this form.**

This Space For Filing Use Only

1. SECRETARY OF STATE FILE NUMBER

2. NAME OF LIMITED LIABILITY COMPANY

3. COMPLETE ONLY THE SECTIONS WHERE INFORMATION IS BEING CHANGED. ADDITIONAL PAGES MAY BE ATTACHED IF NECESSARY.

**A.** LIMITED LIABILITY COMPANY NAME (END THE NAME WITH THE WORDS "LIMITED LIABILITY COMPANY," "LTD. LIABILITY CO." OR THE ABBREVIATIONS "LLC" OR "L.L.C.")

______________________________________________

**B.** THE LIMITED LIABILITY COMPANY WILL BE MANAGED BY (CHECK ONE):

[ ] ONE MANAGER
[ ] MORE THAN ONE MANAGER
[ ] ALL LIMITED LIABILITY COMPANY MEMBER(S)

**C.** AMENDMENT TO TEXT OF THE ARTICLES OF ORGANIZATION:

**D.** OTHER MATTERS TO BE INCLUDED IN THIS CERTIFICATE MAY BE SET FORTH ON SEPARATE ATTACHED PAGES AND ARE MADE A PART OF THIS CERTIFICATE. OTHER MATTERS MAY INCLUDE A CHANGE IN THE LATEST DATE ON WHICH THE LIMITED LIABILITY COMPANY IS TO DISSOLVE OR ANY CHANGE IN THE EVENTS THAT WILL CAUSE THE DISSOLUTION.

4. FUTURE EFFECTIVE DATE, IF ANY: MONTH DAY YEAR

5. NUMBER OF PAGES ATTACHED, IF ANY:

6. IT IS HEREBY DECLARED THAT I AM THE PERSON WHO EXECUTED THIS INSTRUMENT, WHICH EXECUTION IS MY ACT AND DEED.

______________________________ ______________
SIGNATURE OF AUTHORIZED PERSON DATE

______________________________
TYPE OR PRINT NAME AND TITLE OF AUTHORIZED PERSON

7. **RETURN TO:**

NAME
FIRM
ADDRESS
CITY/STATE
ZIP CODE

SEC/STATE FORM LLC-2 (Rev. 03/2005) – FILING FEE $30.00 APPROVED BY SECRETARY OF STATE

Six **types of vestings** are available for ownership interests held by individuals in real estate or personal property (shares in the LLC) located in California:

- joint tenancy;
- community property;
- community property with right of survivorship;
- tenancy in common;
- sole and separate ownership (single, unmarried, spouse); and
- revocable living (inter vivos) trusts or other title holding arrangements.

Vesting is not only evidence of who owns an interest in property, vesting is a method of estate planning for stating the nature of the ownership (community or separate) and distribution of the interest on the owner's death (by the right of survivorship, will or trust).

Two or more individuals may vest the percentage of LLC membership interest they jointly own in "joint tenancy," such as "husband and wife as to a 20% interest, as joint tenants."

On the death of one of the joint tenant members, the surviving joint tenant who co-owned the interest with the deceased automatically succeeds as owner to the entire membership interest they had jointly held in the LLC. [See Chapter 34]

The **sole advantage** of a joint tenancy vesting for a co-owned interest is the avoidance of probate. The same results occur when the husband and wife vest their co-ownership as community property with the right of survivorship.

## Managing a deceased member's interest

When a limited liability company (LLC) member dies, the member's legal representative, such as an executor, administrator or trustee, may exercise all of the member's rights in the LLC for the purpose of administering and securing the **deceased member's estate**. [Corp C §17304(a)]

LLC operating agreements typically include provisions allowing the remaining members to **terminate a member's interest** upon his death, unless the deceased member's interest is held by a surviving joint tenant who co-owned the interest with the deceased. [See Figure 1]

Thus, the remaining members can purchase the deceased member's terminated interest under the buy/sell provisions in the LLC operating agreement. [See Figure 1]

If the option to buy out the deceased member's interest is not exercised, the remaining members are under no obligation to approve the deceased's legal representative as a new member of the LLC. If they do not, the representative or any other successor of the deceased's interest may not vote or become involved in the governing of the LLC and the manager's administration of the LLC or its property.

# Chapter 37 Securities aspects of LLC syndication

*This chapter discusses the securities risk that exist in real estate development, financing and business operations co-owned as a group investment.*

## Excludes the economic risks of real estate

Bringing together a group of investors for real estate syndication as a limited liability company (LLC) or other form of co-ownership, requires an understanding of the social purpose underlying state and federal securities laws if the syndicator is to avoid **ownership activities** that become securities violations.

The classic definition of a *security* under federal law is comprised of:

- an **investment** of money;
- a **common enterprise** based on the mutual success or failure of the group in its investment goals; and
- an **expectation of profits** produced by the **efforts of others**. [**Securities and Exchange Commission** v. **W. J. Howey Co.** (1946) 328 US 293]

In application, the purchase and ownership of real estate by any group of investors involves both the elements of an **investment** and a **common enterprise**. Thus, the syndicator's formation of a group for an investment in real estate has the potential for creating a *securities risk*.

However, to create a security, the investment program must contain the third element of profit produced by others through an activity that creates property value. A **securities risk** arises when the investor releases control of his cash contribution, and it remains under the syndicator's control until the promised, value-creating activity is completed.

The risk created by including an activity that **creates value** distinguishes the group investment that contains the securities risk from a group investment that does not present a securities risk and is not controlled by the securities law.

To be a security, the investment program sold to the group of investors must provide for a **return of the original investment** based on a promise, by the syndicator or someone else, of future physical development or other change of use for the real estate acquired, that must be completed before the investment goal can be attained.

However, the mere formation of a group of investors by a syndicator to purchase and operate an existing income-producing real estate project for annual income or hold land for profit on resale, does not involve a securities risk. Here, the expectation of a return is based on the performance of the property in the marketplace, economic conditions that affect all properties. The investors are not counting on the efforts of the syndicator or any other person to produce improvements or to develop a use for the property after the invested money has been released from the investor's further control.

Also, an LLC is merely a **business structure** used as a form of group ownership in a real estate investment program. Thus, offering cash investors fractional membership interests in an LLC (or as tenants in common) formed to fund the acquisition of an existing income-producing property is not, without analyzing the syndicator's activities in the investment program, the offering of a security.

Conversely, an investment group formed to develop real estate or undertake an ongoing resale marketing program, farming operation or business opportunity contains securities risks, regardless of the entity or form of vesting chosen for the group.

A corporate securities risk is created by placing the investors' capital at a **risk of loss** before the property can be placed on the market for rent or for sale due to the need to:

- complete significant value-adding activities after the acquisition of the property; or
- select a property to be acquired after investors have relinquished control of their cash (a blind pool).

An investment program that involves an activity that constitutes a securities risk imposes a duty on the syndicator creating the program and soliciting investors' capital to comply with the securities law. Exemptions exist that remove some investment programs containing securities risks from control under the securities law.

Unless exempt, the syndicator first reports to the appropriate government agency:

- the California Department of Corporations (DOC) to comply with state securities rules (for qualification under a permit); or
- a registration with the Securities Exchange Commission (SEC) to comply with federal law.

Failure to qualify or register the sale of non-exempt corporate securities exposes the syndicator who creates the securities risk to civil and criminal liability.

A properly selected and structured investment program avoids ownership activities that place the investors' capital at a risk of loss after acquiring the property, such as after-closing development, asset selection or collective coordination with others (rental pooling). These ownership activities create a relationship between the investors and the syndicator that is classified as a *corporate security*.

## Existing asset vs. securities risks

A group of investors formed as an LLC purchases a newly constructed, but unoccupied apartment building. The syndicator who solicited the investors' funds serves as manager for the LLC and the property. The LLC members have the right to cancel the property management agreement with the syndicator by removing him as the manager on 30 days' notice.

The investment program eventually fails to be a financial success. The local economy does not produce enough tenants to occupy the property and provide sufficient rental income to pay operating expenses and installments on the purchase-assist loan.

The LLC co-owners make a demand on the syndicator for a return of their investment, plus interest. They claim the purchase of the complex, when coupled with the property management agreement, created a corporate security that was neither exempt from the securities law nor qualified by the DOC. The co-owners claim they relied on the syndicator's **management expertise** to rent out units of the newly constructed building and create a *return on the capital* they invested in the LLC.

Does the syndicator who merely manages property in competition with other like properties impose a liability on himself for the return of the co-owner's capital?

No! A corporate security is not created solely by the existence of a property management related activity or the promise or expectation on an annual return on their investment. The members **retained control** over the management of the property, based on their right to terminate the property management agree-

ment and the manager by a vote of the members. Further, they could replace management with readily available management as a service offered in the brokerage community.

Here, the investors did not place their capital at risk in reliance on the skill and effort of another to **create value** in the property. Instead, they acquired a fully improved, existing asset in exchange for the funds invested, on the chance the market place will allow their investment to prosper. Also, they retained ultimate control over management since they could change management at any time. The investors bought the property as the investment, not the syndicator's management expertise (which was, instead, the subject of the property management agreement). [**Fargo Partners** v. **Dain Corp.** (8th Cir. 1976) 540 F2d 912]

Now consider a syndicator who sells small parcels of agricultural land planted with citrus trees to individual investors. Under a **service agreement** attached to each purchase agreement, the syndicator will care for the trees and harvest and market the fruit produced by the trees under his management. The term of the service agreement is 10 years.

The syndicator manages the groves on all the separate parcels by coordinating the ownership and operations of all the parcels as a single, large-scale farming operation. The syndicator has the knowledge and equipment required to conduct a successful farming operation and to **produce and sell** the crop. Each investor is to receive a share of the syndicator's net operating income from the crop production based on their pro rata ownership of all parcels farmed under the service agreement, called a *pooling arrangement*.

In contrast to the co-ownership of an apartment building by several investors who employ the syndicator as the manager to locate tenants and rent existing units, an investment in a parcel of agricultural land, operated as a farming business that is coordinated and managed by the syndicator, contains a corporate securities risk. The investors rely solely on the expertise of the syndicator to create a return of their invested funds by **producing a crop**, then harvesting and selling it. Further, he agreed to do so in cooperation with owners of other properties in a *pooling arrangement*.

Here, an investor who might cancel the service agreement with the syndicator will not be able to independently operate his parcel of land and its grove with any economy if it is separated from the others, or readily hire another operator to coordinate with the other owners to farm the parcels as a *collective* to produce and market crops. The **financial success** of the operation requires all the parcels in an economy of scale to be operated as one, using special equipment and skills possessed by the syndicator.

Thus, even though the transaction was structured as a sale of a parcel of real estate to an individual purchaser combined with a service agreement, the related series of transactions display the critical elements of a corporate security — a group investment with an expectation of profits and success inextricably interwoven with the efforts of others to produce a crop to generate an income and, ultimately, a return of the investment. [Securities and Exchange Commission., *supra*]

## Protecting the investor

The state and federal corporate securities laws exist to protect investors who risk their capital in **asset-creating investment schemes** offered by others. The purpose is to give the investors a reasonable opportunity to realize profits on the investment.

A securities risk is created under California securities law whenever:

- an investor places his funds at risk of loss; and

- assumes a passive role, giving control of essential asset selection, development, pooling or resale decisions exclusively to the syndicator or others.

A security is created when the syndicator or others promise to perform an activity that **creates value** after the close of the purchase, an activity that must be completed successfully before value is added to the property and a return on or of capital can be expected.

In essence, the investor did not invest in an existing asset, but in the skill of someone else to create that valuable asset in the future. The invested funds are no longer controlled by the investor, but by the syndicator or others. Activities that occur after closing and create a **securities risk** include:

- locating and selecting a property for acquisition, called a *blind pool*;
- obtaining government approval or permits for zoning or use of the property;
- further improvement or significant alteration of the property; or
- operating a business or farming operation that requires expenditures for inventory, production or sales.

Thus, for a security to exist, the syndicator must undertake an ongoing investment activity that continuously places the investor's capital at risk of loss until the promised activity is completed. The securities risk is contained in the management of money, whether obtained from the investors or borrowed funds, to improve the property, create the crop or obtain agency approvals for a new use to fulfill the purpose of the investment.

Examples of activities that include a securities risk for investors in syndicated real estate transactions include:

- subdividing, improving or reselling the real estate (dealer activities);
- operating a business on the premises acquired rather than merely managing the rental of the real estate or the ownership of vacant land; and
- buying and selling to maintain a portfolio of trust deeds.

The California securities law is designed to give investors a fair chance of realizing investment objectives promised to be completed by others. The syndicator is responsible for returning the investor's capital if promises are not fulfilled to complete after-closing activities that create the significant value necessary to provide for a return of the investors' contributions. [**Silver Hills Country Club** v. **Sobieski** (1961) 55 C2d 811]

## Controlled investments

The securities issue for the syndicate manager is to determine which investment activities do and which do not include risk situations that trigger the application of the securities law.

The existence of a security is a matter of the *substance* of the transaction, not the *form* it has been given. The economic function of the transaction, rather than the title the transaction bears or the type of business form used, determines whether a securities risk exists.

*Editor's note — An exception to the substance-over-form rule is the issuance of* ***stock****. Any transaction that involves the issuance or transfer of investment certificates, which are formally called stock, is a controlled security, regardless of the economic substance of the investment in the "stock." [****Landreth Timber Company*** *v.* ***Landreth*** *(1985) 471 US 681]*

For example, the citrus grove investment program in *W.J. Howey Co.* was structured as a sale of a parcel of improved agricultural property. Each investor became the sole owner of an individual parcel of land — a real estate sales situation that, without further involvement after the acquisition, does not contain a securities risk.

However, each owner has no reasonable ability to **independently control** or operate the property and farming business they bought into. Success was entirely in the hands of the syndicator to create a return of their invested funds through the husbandry, production, marketing and sale of the crop, and the coordination by *pooling* with other owners.

Next, consider an investor who purchases a condominium unit through a real estate broker. Normally, the purchase of a residential unit does not constitute a corporate security. However, the broker also arranges for the buyer to enter into a *rental pooling agreement* (RPA) with a vacation rental management company for the ongoing operation of the property. The broker has no connection to the management company employed in the RPA and receives no kickback or fee for the referral.

Under the RPA, the management company oversees rental operations for the entire project in which the investor's unit is located. As managers, they distribute spendable rental income (rent minus expenses) to the investors of individual units based on each of their pro rata share of ownership participation in the RPA, not based on the actual performance of each separate unit, an activity called *rental pooling*.

The RPA is a major inducement for the investor to purchase the condominium unit. The pooling arrangements will enable him to locate tenants, rent the unit and collect rental income without being personally responsible for the day-to-day management of his unit. Critical to the investment is the sharing of investment risks; he will share the income and expenses with everyone else within the "pool." More strategically, the investor plans to cover his monthly payments on the condominium out of the rental income.

Ultimately, due to market forces, not management, the unit fails to produce the level of rental income the investor expected. The investor seeks to recover his investment from the broker, claiming the purchase of the condominium coupled with the RPA was a corporate security, since the investor relied on the management efforts of others in the **joint operation** of several units to produce a return of his investment.

The broker claims he did not create a corporate security since the investor was not required to enter into the RPA as part of the agreement to purchase the condominium, and the broker was not in control of the management of the property. Did the broker create a corporate security by arranging an RPA for the investor?

Yes! The purchase of the condominium unit coupled with the RPA was presented to the investor as a single investment scheme. The investor was induced to invest his funds in the common enterprise based on an **expectation of profits** produced by the efforts of others in a "pool and split" program — even though the broker himself was not the person responsible for coordinating the rental pooling effort.

Since the broker induced the investor to place his funds at risk on the close of escrow in anticipation of a future return generated by the efforts of others — the pooling and management of several separately owned properties under the RPA — a securities risk was created. [**Hocking** v. **Dubois** (9th Cir. 1989) 885 F2d 1449]

## Subdivided parcels sold to groups

Now consider a developer who acquires a large parcel of real estate for the development of a planned community. The developer sells parcels within the planned development to groups formed as LLCs. The parcels are advertised as being suitable for development as part of the planned community.

The developer does not promise to develop the parcels sold to the LLCs or to produce profits for the LLCs based on the development of the entire project, adjacent parcels, off-site infrastructure or a pooling arrangement.

One group of investors who acquired a parcel in an LLC makes a demand on the developer and his broker for a return of their investment, claiming a security was created since they relied on the developer to complete the development of the planned community, which did not occur.

However, the group of investors had complete control over the parcel it acquired from the developer — nothing remained to be done after acquisition, except for the investors to wait for the market to deliver a profit or loss. Thus, no securities risk was created. The transaction was merely a sale of real estate to the LLC, to hold for a profit on resale or later development as the group saw fit. [**De Luz Ranchos Investment, Ltd.** v. **Coldwell Banker & Company** (9th Cir. 1979) 608 F2d 1297]

## Risk capital tests

State and federal courts apply slightly different tests to determine whether a securities risk exists in an investment program. In California, courts apply the *risk capital test* to determine whether a real estate transaction requires securities law protection.

The California risk capital test requires the investors' capital to simply be placed at risk in an activity controlled by the securities laws, **whether or not a profit** is expected or intended. Compared to federal securities law, the California securities law is further-reaching and covers more investment conduct.

The federal risk capital test, on the other hand, revolves around the element of the expectation of a profit on the investment. For a security to exist under the federal **risk capital test**, the investors must be induced to join the program by, among other activities, a promise that they will profit from their capital investment.

## Personal use coupled with development

Under the California rule, a syndicator's mere promise of future profits does not create a securities risk unless it is accompanied by the promise to perform an activity that creates value, such as development.

For example, a developer sells investors memberships in a yet-to-be-built country club. Later, when the developer fails to complete construction of the country club, the investors make a demand on the developer for a return of their investment. They claim the developer violated California securities law since the club memberships sold were unqualified and non-exempt securities in a construction project.

The developer claims the country club memberships are not controlled by California securities laws since the memberships merely provide for personal recreation and involve no expectation of a profit.

However, unlike federal securities law with its profit-driven test, an expectation of profit is not of concern to the California securities law. Here, the sale of memberships was coupled with a securities risk. The investors risked their capital on a "yet-to-be-built" project, relying on the developer to **complete**

**the construction** of the country club after the members released their investment funds to acquire their group ownership of the property. [Silver Hills Country Club, *supra*]

**Promised returns without development**

To avoid creating a security under California's risk-capital test, the selection of a specifically identified parcel of real estate for acquisition must exist **before** the release of invested funds. Even then, the only business that may be conducted after acquiring the property is either the location of tenants and rental of the property or the ultimate resale of the unaltered property at a profit.

If, on closing a purchase escrow, the investor receives **full value** for his investment in the form of a fixed asset, such as a share ownership in an existing parcel of real estate, no security is created. The investor's invested capital is no more at risk than had he purchased the asset outright, with or without a promise of profits. [**Hamilton Jewelers** v. **Department of Corporations** (1974) 37 CA3d 330]

In another example, a syndicator locates real estate he decides to syndicate. On completing his due diligence investigation and analysis, a detailed **investment circular** is prepared. The circular states the real estate will not be developed or improved, but simply owned and operated for what it is — a rental income property.

The investors solicited by the syndicator know they will receive an existing fixed asset for their money. The property will not be altered, further improved or converted to another use after acquisition. Thus, their capital is not subjected to a securities risk — only the **economic risks** of locating tenants and incurring expenses in the rental marketplace as experienced by all property owners.

All money invested in real estate is, to some extent, at risk of loss due to fluctuating property values brought about by economic conditions, hazards, etc., called *marketplace risks*. However, marketplace risks merely affect the level of income, profit or loss. Income and profits (or loss) from ongoing rental operations in the local economy are not the concern of securities laws.

## Exemptions when securities risks exist

A large number of investments that contain a securities risk are *exempted* by statute from control under the securities law.

Investment programs offered by banks and savings and loans (S & Ls) are exempt from securities law, as are nonpublic offerings.

The **non-public offering exemption** is the most useful exemption available to syndicators who put together an investment program which includes an activity containing a securities risk. The non-public offering exemption, called the *35-or-less interrelationship rule*, applies if:

- the investors do not number more than 35 (husband and wife counting as one);
- all investors have a meaningful, pre-existing business or personal relationship with the syndicator;
- the investors will not resell or distribute the interests they acquire; and
- the solicitation of investors does not involve public advertising. [Calif. Corporations Code §25102(f)]

Thus, even if an investment program does contain securities risks, such as exists in a construction or development project, the syndicator does not need to be further concerned with the securities law if his program meets the requirements of the 35-or-less interrelationship rule for the nonpublic offering of a

security. If a securities risk does not exist in the investment program, the **solicitation of investors** from the public is not an activity which itself places the investors' funds at risk.

## Disclosure of securities and the statute of limitations

Consider a syndicator whose investment program contains a securities risk activity. To solicit investors, he posts his offering in the recreational rooms of condominium projects and mobilehome parks he has an interest in. He does not obtain a permit nor does he register the sale of the investment program with the DOC or SEC.

Here, the syndicator publicly offered his investment opportunity containing a securities risk to anyone visiting the recreational rooms. Thus, his investment program was a **non-exempt offering** of a security. As a result, if the investment fails, any investor in the program can recover the full amount of his investment from the syndicator, plus 10% interest from the date of investment and less any distributions the investor has received. [Corp C §25503]

However, the investor's recovery of his investment under California securities laws is subject to a *statute of limitations*. The limitation places a time deadline beyond which an investor is barred from filing a claim for the recovery of money. An action to recover the investor's funds must be filed within the earlier of:

- two years after the date the investor funds the investment; or
- one year after the investor's discovery of the violation of securities law. [Corp C §25507]

If the syndicator, as part of his investment memorandum, discloses securities permits have not been obtained, the investor will be aware of the potential violation from the beginning. Thus, the investor's recovery under the California securities law will be subject to the one-year statute of limitations for filing his complaint.

Until the one-year limitations period expires, the investor in an investment program that contains a securities risk and does not qualify for an exemption or was not qualified for investors by the DOC, may unilaterally withdraw his investment funds at any time (plus interest and less any distribution of earnings). However, when the year period has expired following disclosure and the close of escrow, the syndicator is no longer liable for any claims for securities violations and civil money damages.

Realistically, if an investor is willing to contribute his funds to a real estate syndication in the first place, he is unlikely to withdraw and file an action within one year. Real estate investments are unlikely to go sour within one year.

Thus, even if the syndicator is certain his investment program contains no activities that are securities risks and would place the investors' funds at risk of loss after acquisition of the property, a disclosure that no permit exists limits the syndicator's exposure to liability by commencing the one year statute of limitations.

# Chapter 38 The statutory purchaser's lien

*This chapter presents a purchaser's lien as a means for a buyer to enforce a return of monies paid toward the purchase price when the seller breaches their purchase agreement.*

## Foreclosing on the seller's property

A real estate broker employed by a seller as his listing agent misrepresents to a prospective buyer the construction costs incurred by the seller for a building located on a parcel of real estate. The misrepresentations result in the buyer and seller entering into a purchase agreement. The buyer makes the agreed down payment on the purchase price and escrow closes.

After the close of escrow, the buyer constructs further improvements on the property and pays property taxes and insurance premiums. Later, the buyer learns the broker misrepresented the costs incurred by the seller to construct the improvements.

The buyer demands that the seller return all monies paid on the purchase price, the cost of the additional improvements and the property taxes and insurance premiums, an action called *rescission*. The buyer reconveys the real estate to the seller, a transaction called *restoration*.

Does the buyer have a remedy against the seller to recover the payments made toward the purchase price and the expenses related to the property?

Yes! The buyer is entitled to a *purchaser's lien* which he can foreclose on the property he reconveys to the seller as part of the recovery process called **rescission and restoration**. The **purchaser's lien** is for the amount of payments made on the purchase price, plus expenditures made to improve the property and pay property taxes and insurance premiums. [**Montgomery** v. **Meyerstein** (1921) 186 C 459]

From the moment a buyer enters into a purchase agreement with a seller to acquire property, he has an interest in the seller's property, called an *equitable ownership*. This property interest entitles the buyer to a statutory lien against the property for **amounts paid** on the purchase price if the seller fails to deliver as agreed. [Calif. Civil Code §3050]

The amount of the purchaser's lien will be *offset* by any rent the buyer receives or the implicit rental value of the buyer's use of the property while he is in possession. [Montgomery, *supra*]

## The buyer's right to a lien

The right to a **purchaser's lien** for monies paid includes situations where the seller:

- fails to deliver the property as agreed;
- interferes with the buyer's right to possession;
- fails to sign and deliver agreements or documents;
- induces the buyer to enter into the purchase agreement by misrepresentation; or
- attempts to avoid his performance on the purchase agreement.

Additionally, a buyer is not entitled to a purchaser's lien if a seller's nonperformance is excused due to a breach by the buyer. [Montgomery, *supra*]

## Foreclosing the purchaser's lien

The right to a purchaser's lien permits a buyer to record a **lis pendens** on the property purchased while seeking a court ordered foreclosure of the property to satisfy the purchaser's lien. The seller's property under contract with the buyer is considered security for repayment of the money the seller owes the buyer. Any deficiency in the property's value after the foreclosure sale becomes a money judgment against the seller.

For example, a buyer and seller enter into a purchase agreement. The purchase agreement calls for the buyer to make a down payment on the purchase price. The seller agrees to carry back a note and trust deed for the dollar amount remaining to be paid on the purchase price.

The buyer tenders the down payment and signs and delivers the note and trust deed to the seller. The buyer is given possession of the property. The seller's grant deed and the trust deed are not recorded.

The seller later refuses to record the grant deed and convey title to the buyer as agreed. Due to the seller's breach of their purchase agreement, the buyer decides not to complete his purchase and restore the property to the seller. He then commences an action to establish and foreclose on a purchaser's lien for the amount paid towards the purchase price.

The seller claims the buyer is not entitled to a purchaser's lien since the buyer failed to first give the seller a notice of rescission or demand a return of the money paid.

However, by seeking a purchaser's lien on the property, service of the complaint in the action is notice of the **buyer's rescission** of the purchase agreement. Since the seller breached the purchase agreement by failing to convey the property, called a *material breach*, the buyer is entitled to treat the purchase agreement as terminated and seek recovery of the money previously paid on the purchase price without prior notice.

In addition to being entitled to the purchaser's lien by statute, the buyer is also allowed to **judicially foreclose** and sell the real estate under the purchaser's lien. [**Lockie** v. **Co-Operative Land Co.** (1929) 207 C 624]

The seller is entitled to receive an offset from the amount he owes the buyer for the rental value of the property for the period the buyer occupied the property.

## Purchaser's lien priority

The **priority** of a purchaser's lien on title is set as of the date the buyer is *given possession* under the purchase agreement, called the *relation back theory*.

A purchaser's lien gives a buyer who takes possession of a property priority over all later buyers or lenders who acquire an interest in the property without the buyer's consent. Due to the buyer's possession of the property, future buyers and lenders have constructive knowledge of the original buyer's interest in the property, which includes the implicit right to a purchaser's lien.

Later buyers or lenders are considered to be aware of an original buyer's interest in a property if:

- the record title to the property, such as a recorded land sales contract, lis pendens or other document, gives notice of the original buyer's interest;
- the later buyer or lender has knowledge of the purchase agreement; or
- the original buyer's possession of the property is inconsistent with the record title.

Consider a buyer and seller who enter into an oral land sales contract. The property is encumbered by an existing first trust deed.

Before the buyer is given possession of the property, the trust deed lender advances additional funds to the seller under the *future advances clause* in the trust deed.

The buyer later takes possession of the property and makes all payments on the land sales contract directly to the trust deed lender. The trust deed lender accepts the buyer's payments with full knowledge of the land sales contract between the buyer and the seller.

Later, the trust deed lender advances additional funds to the seller, again under the **future advances** clause in the trust deed.

Meanwhile, the buyer pays the lender all amounts owed on the first trust deed note at the time the buyer took possession of the property. However, he does not also pay the amount advanced to the seller by the lender after he took possession. The buyer makes a demand on the lender to release the trust deed lien on the property, called a *reconveyance*.

The lender refuses to reconvey the trust deed unless all advances are repaid, an amount greater than the amount due to the seller on the land sales contract.

Due to the fact that the seller is unable to clear title to the property as agreed to under the oral land sales contract, the buyer seeks to enforce a purchaser's lien on the property for all his payments advanced toward the purchase price. Further, the buyer claims his purchaser's lien has priority over the lender's unpaid advances since his purchaser's lien relates back in time to the date the buyer took possession of the property under the unrecorded land sales contract.

In this example, the purchaser's lien has priority over all advances made by the trust deed lender after the date the buyer took possession of the property under the land sales contract. Advances made to the seller by the lender prior to the buyer's possession are senior to the purchaser's lien.

Alternatively, the buyer may *quiet title* to the property and extinguish the trust deed of record since the trust deed lender has been paid all amounts owed under the first trust deed on the date the buyer took possession of the property under the land sales contract. [**Garcia** v. **Atmajian** (1980) 113 CA3d 516]

### Buyer in default

A purchaser's lien only arises if a buyer's failure to perform as agreed in the purchase agreement is *excused* due to wrongful actions by the seller.

For example, a buyer makes a good faith deposit with his offer to purchase a property. The good faith deposit is placed in escrow to be applied to the purchase price on the close of escrow. The seller hands his grant deed to escrow for delivery to the buyer on closing.

The buyer fails to place the entire amount of the down payment in escrow when escrow calls for funds, and thus escrow does not close. The seller refuses to release the buyer's good faith deposit from escrow by returning it to the buyer.

The buyer seeks to establish a purchaser's lien on the seller's property for the amount of the good faith deposit in escrow, claiming the seller can not forfeit the buyer's deposit.

Is the buyer entitled to a purchaser's lien when it is the buyer who is in default under the purchase agreement?

No! A purchaser's lien will not exist in favor of the buyer who defaults. Thus, the buyer who breached the purchase agreement by refusing to perform according to its terms is not entitled to a purchaser's lien to secure any amount. [**Merrill** v. **Merrill** (1894) 103 C 287]

However, the seller is not automatically entitled to retain the buyer's deposit in escrow on the buyer's default. A forfeiture of the funds is not allowed even if the buyer's breach is deliberate. [CC §1057.3]

Instead, the seller is entitled to an offset against the buyer's deposit for any recoverable money losses incurred by the seller due to the buyer's breach. [**Allen** v. **Enomoto** (1964) 228 CA2d 798]

## Recovering the value of improvements

A purchaser's lien covers all monies paid out by a buyer for expenses and improvements on a property. [Montgomery, *supra*]

However, for a buyer to recover his expenditures on a property, the breach cannot be caused by the buyer.

For example, a buyer agrees in a purchase agreement to buy a parcel of real estate on which a water pumping plant is located. For consideration, the buyer agrees to lay water mains on adjacent property retained by the seller of the parcel. The buyer will also provide irrigation service to the adjacent property. These promises to perform are not secured by a performance trust deed on the property purchased. [See **first tuesday** Form 451]

The seller performs as agreed under the purchase agreement by conveying the parcel with the water pumping plant to the buyer. The buyer takes possession of the parcel on which the water pumping plant is located and completes some of the promised improvements on the seller's adjacent property.

However, the buyer fails to complete all of the improvements as agreed, **reconveys** the property to the seller and makes a demand on the seller for the cost of the improvements the buyer made.

The buyer claims he is entitled to a purchaser's lien on the property reconveyed to the seller for the value of the completed improvements on the adjacent property, with priority to any interest of the seller.

However, the default in the purchase agreement was due to the buyer's failure to complete the agreed upon improvements. Thus, the buyer is not entitled to a purchaser's lien on the property for the cost of the improvements he completed. [**Wilson** v. **Smith** (1924) 69 CA 211]

## Quiet title action by breaching seller

Consider a buyer and seller who enter into a purchase agreement.

The buyer makes a good faith deposit which is deposited into escrow. Before closing, the buyer discovers a defect in the title to the property being purchased and makes a demand on the seller to clear title and close escrow.

The seller cannot convey a marketable title since a title company will not insure his conveyance as agreed to in the purchase agreement.

The buyer refuses to complete the transaction and demands a return of his deposit since the seller failed to deliver marketable title as agreed. However, the seller refuses to release the buyer's deposit from escrow.

The buyer files an action to impose and foreclose a purchaser's lien on the property to recover the deposit which the seller will not release. The seller counters with a quiet title action to clear title of the buyer's purchaser's lien.

Is the seller entitled to prevail on his quiet title action?

No! The seller may not quiet title and extinguish the purchaser's lien held by the buyer until the seller returns to the buyer all monies paid toward the purchase price by the buyer. [**Benson** v. **Shotwell** (1890) 87 C 49]

# Chapter 39 Unsecured carryback sellers

*This chapter examines a seller's use of a vendor's lien when the buyer owes unsecured amounts remaining to be paid on the purchase price after the close of escrow.*

## Vendor's lien allows foreclosure

Consider a seller whose equity in his income-producing real estate is less than 20% of the value of the property. Also, the rental income produced by the property is insufficient to pay its operating costs and the loan payments. Thus, a negative cash flow exists on the property.

The seller wants to sell the property to rid himself of the carrying costs and avoid what he anticipates will be a further decline in its value.

A creditworthy buyer is located who sees potential in the property and has substantial net worth according to his financial statements.

The buyer offers to buy the property at a price based on:

- a 5% down payment;
- the assumption of the existing first trust deed loan equal to 80% of the price; and
- the seller carrying back a trust deed note for 15% of the purchase price.

The seller and his broker know a carryback note secured by the property sold is *nonrecourse paper*. Thus, the carryback seller must look exclusively to the equity in the property he sold to recover on the note should the buyer default. A money judgment for any deficiency in property value is barred by **anti-deficiency** laws. [Calif. Code of Civil Procedure §580b]

Further, if the buyer defaults on the first trust deed loan, the seller will face the loss of his second trust deed on a foreclosure by the first trust deed holder. A default on the first trust deed would force the seller to either bring the first trust deed current and keep it current, or pay it off, to avoid seeing his trust deed wiped out at a foreclosure sale by the first trust deed holder.

However, the property lacks sufficient equity to allow the seller to foreclose and recover on a carryback note which would be junior to a first trust deed loan with an 80% loan-to-value (LTV) ratio. The ability to foreclosure under such conditions poses little financial incentive for carrying back a trust deed to secure the carryback note.

As disclosed by his broker, the costs to foreclose, carry and resell the property would equal about 20% of the property value by the time of the resale. Much of these costs will be paid in cash before reacquiring and reselling the property. [See **first tuesday** Form 303]

The financial position of the carryback trust deed would not justify foreclosing and taking back the property unless the property's value increases in excess of 10%, which is an unlikely development in the flat or declining real estate market the seller is experiencing.

## Little equity: go unsecured

Continuing with our previous example, the seller agrees to carry back a note, but it will not be secured by a trust deed on the property sold. Thus, the carryback seller will avoid the nonrecourse risk of not being able to recover for failure of the property's value to cover the trust deed loan and his carryback note. The risk of loss inherent in a nonrecourse note would have existed had the carryback note been secured by a trust deed on the property sold, called the *value-deficiency risk*.

Now consider another seller whose equity is about 40% of the value of the property he wishes to sell.

A buyer makes a no-cash offer to buy the property, agreeing to take over the existing first trust deed and execute two notes in favor of the seller. One note is for 20% of the purchase price and will be secured by the property. The other note is for the remaining 20% of the price and will be unsecured.

The buyer has substantial net worth, including equities in other real estate he owns. However, the buyer does not want to use the other real estate he owns as primary, additional or substitute security for either of the two carryback notes. [See **first tuesday** Form 154]

The buyer wants the real estate he presently owns to remain unencumbered so he has easy access to cash to manage his real estate acquisition programs.

Do the sellers in both of these unsecured carryback examples have any remedy if the buyers default on the unsecured carryback notes, besides obtaining a judgment for monies due on the notes?

Yes! The carryback sellers also have a *vendor's lien* on the property they sold. The lien will allow the sellers to foreclose on the property for the amount of the purchase price which remains unpaid. The lien was not waived since the debt owed to them by the buyers was always unsecured. [Calif. Civil Code §3046]

On a default in payment, the seller can choose to exercise his **vendor's lien** and f**oreclose** on the property sold. However, unlike a money judgment lien which attaches to all properties owned by the debtor, the vendor's lien only attaches to the property sold, and only if the **buyer still owns it**.

If the value in the property is insufficient to recover the unsecured balance remaining due on the purchase price, the seller can obtain a money judgment for the deficiency. The seller can also obtain a money judgment if the vendor's lien is wiped out by a foreclosure sale on the first trust deed or no longer available due to the buyer's resale or further encumbrancing of the property to a third party who does not have knowledge of the fact the buyer still owes the seller payments on the purchase price.

On obtaining a money judgment for a deficiency in value, an **abstract of judgment** is recorded. Unlike the vendor's lien, a judgment lien attaches on title to all of the properties in the county vested in the buyer's name.

Now consider a seller who carries back both a secured note and an unsecured note to evidence **separate amounts** owed on the purchase price, as occurred in our last example.

The buyer defaults on both debts and the seller forecloses on the debt secured by the property sold. On completion of his foreclosure, the seller's right to a vendor's lien for the separate amount owned on the unsecured debt is wiped out. However, the seller is still entitled to a general money judgment for the amount of the unpaid balance remaining on the unsecured note.

Further, if a buyer misrepresents his net worth to the seller to induce him to carry back the unsecured note and then later files a bankruptcy petition, the carryback note is a nondischargeable debt since the seller financing was obtained through the misrepresentation of the buyer. [11 United States Code §523(a)(2)(A)]

### Vendor's lien for error in closing funds

A **vendor's lien** is available to the seller to recover a shortage in the buyer's funds should an escrow officer miscalculate the demand on the buyer for funds to close escrow, leaving escrow with insufficient closing funds from the buyer.

For example, a buyer purchases a parcel of real estate on terms which include his taking title subject to a first trust deed lien of record.

Escrow is opened and a demand is made on the lender to furnish a beneficiary statement needed to determine prorates and adjustments in the loan balance, accrued interest, impounds and insurance, and the amount of cash proceeds to be paid to the seller on the close of escrow.

The first trust deed is an **add-on loan** which computes interest due over the life of the loan and adds it to the principal to set the face amount of the note.

The outstanding balance remaining on the note as stated in the **beneficiary statement** is not the actual principal balance, but is the principal and unaccrued interest over the remaining term of the loan. Thus, the outstanding balance of the debt is stated as an amount which includes the precomputed, unaccrued interest.

Escrow fails to note the loan is an add-on loan or that the payoff amount stated in the beneficiary statement is greater than the amount of principal actually owed by the seller.

The amount due the seller for his equity as calculated by escrow is less than the amount actually due the seller on the close of escrow. The demand on the buyer for **closing funds** is short by the amount of the unaccrued interest included in the loan balance submitted by the add-on lender in the beneficiary statement. The closing is not contingent on the seller receiving and approving an estimated closing statement from escrow.

After closing, escrow realizes its mistake and makes a demand on the buyer for the shortage in cash remaining due on the purchase price. The buyer refuses to pay escrow's demand for the shortage.

The escrow company, acknowledging its mistake, advances the seller the balance still owed on the purchase price. In exchange for full reimbursement, the seller agrees to cooperate with the escrow company's efforts to collect the outstanding balance the buyer owes the seller on the purchase price.

The escrow company will handle all litigation. Accordingly, the escrow company's attorney files, among other claims, the vendor's lien action in the name of the seller. The vendor's lien is an *unassignable equitable interest* which must be pursued in the name of the seller.

In return, the seller agrees to assign any **final judgment** he might receive to the escrow company. Thus, escrow will ultimately recover their cash advances and costs.

A vendor's lien cannot be assigned to anyone, such as the escrow company, since it is an equitable interest in the property sold. It is held personally and solely by the seller. Thus, only the seller can enforce a vendor's lien. [**Avery** v. **Clark** (1891) 87 C 619]

## Establishing a vendor's lien

Vendor's lien rights are not available to sellers for amounts remaining due on the purchase price when legal title to the real estate has not been transferred to the buyer. A vendor's lien is an unrecorded interest held by the seller in the property he sold.

For example, a buyer and seller enter into a land sales contract (or lease-option sale agreement). In it, the seller agrees to convey title to the buyer on the buyer's completion of payments on the purchase price.

The buyer later defaults on payments due under the land sales contract. The seller attempts to obtain a **vendor's lien** against the buyer's interest in the property since the value in the property has fallen below the amount remaining due on the **land sales contract**. If the seller can enforce a vendor's lien, he will be entitled to a money judgment for the deficiency in the property's value to cover the principal balance remaining due on the land sales contract.

The buyer claims the seller, due to his retaining title to the property under a land sales contract, is a secured creditor and is barred from using the vendor's lien to recover the money due on the purchase price.

Is the seller entitled to a vendor's lien?

No! The vendor's lien is *waived* and does not exist when the seller sells real estate and by agreement retains the title (as security) until the amount remaining due is paid. The seller is entitled to a vendor's lien only when he conveys legal title and has not waived his vendor's claim to a lien for the unpaid portion of the purchase price by receiving security for its payment. [**Allen** v. **Wilson** (1918) 178 C 674]

A **land sales contract** is a *security device* evidencing the buyer's debt owed to the seller for the unpaid amount of the purchase price and stating the terms under which the seller retains title to the property. The contract must be foreclosed by sale of the property, even though the property is vested in the seller's name, to terminate the buyer's *right of redemption* which allows the buyer to pay off the land sales contract and obtain clear title.

Thus, a vendor's lien is not a **security device**, as is a trust deed, mortgage, land sales contract or lease-option sales agreement. A vendor's lien is an equitable interest in property, retained by the seller for monies due. The lien does not exist until it is *judicially imposed* in an action brought by the seller and then judicially foreclosed.

## No formal notice for lien

Consider a seller who carries back an unsecured note signed by the buyer. Even though the buyer is not in default, the seller records a document entitled a *notice of vendor's lien*. The recording is an attempt to put future buyers and lenders on notice of the seller's lien rights.

The **notice of vendor's lien** references the property's legal description, the buyer's name, the amount remaining due and unpaid, and states a claim under the vendor's lien statutes. The notice is signed by the seller and his signature is notarized.

Later, the buyer conveys the property to a new buyer who executes a note and trust deed for the remaining amount of the price he owes on his purchase of the property.

The policy of title insurance does not disclose the existence of the prior seller's **notice of vendor's lien**, and the new buyer has no actual or imputed (via his broker) knowledge of the facts giving rise to the seller's lien rights.

After escrow for the resale of the property has closed, the unsecured note held by the original seller becomes delinquent. The seller files an action to foreclose his vendor's lien. The seller claims his lien rights have priority over the buyer's conveyance and trust deed lien entered into after the seller's notice of vendor's lien was recorded.

However, recording the notice of vendor's lien does not create such a lien or affect title. The statute creating the lien does not provide for notice of vendor's lien since only a court can establish the lien. A recorded notice of vendor's lien does not create any rights against future buyers and lenders since it is outside the chain of title as the seller previously conveyed his entire ownership interest in the property.

A **self-serving statement**, by an individual who is no longer on title and has nothing to convey, is not an instrument which transfers or reserves an interest in title to property now owned by someone else. Thus, its recording does not give notice of the lien to later buyers or lenders. A vendor's lien is established as an interest in property only by court order. Except for the cloud of the **lis pendens** in the vender's lien action, the vendor's lien has no effect on title until the court finds that the vendor's lien exists as an *equitable interest* held by the seller in the property and orders the lien to be foreclosed. [**Brown** v. **Johnson** (1979) 98 CA3d 844]

However, a seller will record a lis pendens when he files his action to foreclose on his vendor's lien since the action is a claim for an interest in title. From the time of recording, the lis pendens puts any subsequent buyer or lender on constructive notice of the seller's claim to an interest as a lienholder in the title to the real estate. [CCP §405.24]

## Priority of the vendor's lien

A vendor's lien has *priority* against all later acquired interests in the property sold, except a buyer who purchases the property, or a lender who further encumbers the property, for value and without notice of the seller's rights to a lien. [CC §3048]

Consider a sales transaction on terms involving a new 90% first trust deed loan to be obtained by the buyer to fund his purchase of property. The seller is to carry back an unsecured note for the 10% balance of the purchase price. The lender has received copies of the purchase agreement and escrow instructions stating the seller will not be fully paid in cash and will hold an unsecured note for the balance due on the price when the lender's trust deed is recorded.

The buyer defaults on both the unsecured carryback note and the lender's loan. The lender forecloses on the property under its first trust deed.

The seller claims he has a vendor's lien which is senior to the lender's trust deed since the lender was aware when its trust deed was recorded that the seller had not been paid in full and thus did not receive its interest in the property in good faith.

In this example, the lender has a priority position over the carryback seller's unsecured vendor's lien even though the lender did not have a good faith defense against the seller's vendor's lien and the lender knew the seller had not been paid in full when the lender recorded his loan.

Knowledge of the carryback seller's equitable interest in the property under the vendor's lien law does not destroy the lender's priority position as recorded on title when the secured loan and the unsecured carryback note are concurrently created by conditions stated in the purchase agreement agreed to by the seller. [**Brock** v. **First South Savings Association in Receivership** (1992) 8 CA4th 661]

Now consider a lender who originates a loan secured by property the buyer had previously acquired by executing an unsecured note in favor of the seller as part of the price paid for the property. The lender is aware the unsecured carryback note held by the seller has not been paid.

The loan is not a purchase-assist loan since it was not provided for in the purchase agreement entered into by the buyer and seller, and the proceeds from the new loan do not fund any part of the sales price received by the seller.

Further, the seller does not waive his vendor's lien interest in the property or agree to subordinate it to the lender's trust deed. Thus, should the buyer default on the lender's trust deed and the lender foreclose by a trustee's sale, the seller will retain his vendor's lien rights. Here, the seller's interest has priority over the lender's trust deed. The lender knew the seller had not been paid in full and the loan originated by the lender was unrelated to the sales transaction which produced the seller's right to a vendor's lien. [**McGreevy** v. **Constitutional Life Insurance Company** (1965) 238 CA2d 364]

Additionally, a vendor's lien is given priority over a **judgment lien** against a buyer. A judgment creditor is not a *bona fide encumbrancer* since the abstract of judgment lien is not an encumbrance for value, whether or not the judgment creditor has knowledge of the seller's lien rights in the property. [**Schut** v. **Doyle** (1959) 168 CA2d 698]

## Waiver of vendor's lien

A seller can *waive* his right to a vendor's lien by his conduct. For instance, a seller holds an unsecured carryback note which he sells and **assigns** to an investor.

Here, by the assignment of his unsecured carryback note, the seller waives his vendor's lien right since he no longer is owed money by the buyer. The right to a vendor's lien is **personal** to the seller and cannot be transferred to another person. [CC §3047]

Additionally, a seller waives his vendor's lien rights by taking any security, such as stock, to assure payment of the balance due on the purchase price. [McGreevy, *supra*]

Consider a seller who seeks a money judgment for the unsecured balance outstanding on the sale of his property, since no equity remains in the property sold to justify his pursuing foreclosure of his vendor's lien interest in the property.

If the seller obtains a money judgment on his unsecured note without first foreclosing on his vendor's lien, he waives his right to later enforce his lien since he is no longer owed money on his note, but on a money judgment. Thus, the seller would lose his right to priority over abstracts of judgment previously recorded by other creditors.

Also, when the seller does foreclose on his vendor's lien and is awarded a money judgment for a deficiency in the property's value, his recording of an abstract of judgment for the amount of the deficiency attaches as a lien on all other real estate owned by the buyer. However, the judgment lien on those properties will be junior to all liens of record, whether they are voluntary trust deed liens or involuntary judgment liens.

Finally, the recording by the buyer of a **declaration of homestead** exemption does not interfere with or have priority over a vendor's lien. The buyer knows of the seller's outstanding unsecured debt he owes the seller on the purchase price and is not allowed to avoid the vendor's lien by a claim of homestead. [CC §3048]

# Chapter 40 Mechanic's liens and foreclosures

*This chapter lays out a subcontractor's right to record a lien on title to a construction job site and the notices required to perfect and foreclose on that lien.*

## Obligation to pay for work performed

A landlord enters into a master lease with a tenant who will sublet space to occupants, called *subtenants*. The master lease contains a provision authorizing the **subtenants** to make improvements to their premises without the landlord's prior consent.

A general contractor is hired by a subtenant to make improvements to his property. In turn, the contractor hires a subcontractor who commences work to improve the space. The landlord is not aware of the construction and the subcontractor does not serve the landlord with a **20-day preliminary notice** of the subcontractor's lien rights.

Upon completion of the improvements, the subcontractor is not paid. The subcontractor records a *mechanic's lien* against the landlord's fee interest in the property within 30 days after completion of the work. A lawsuit is filed to foreclose the **mechanic's lien** on the landlord's interest within 90 days after recording the mechanic's lien.

The landlord claims the mechanic's lien is unenforceable since the subcontractor failed to serve the landlord with a 20-day preliminary notice identifying the subcontractor as a supplier of labor and materials to the job site.

The subcontractor claims the mechanic's lien is enforceable without the 20-day preliminary notice based on the landlord's *constructive knowledge* of the construction since the master lease authorized subtenants to make improvements, an authorization which imposes a duty on the landlord to conduct periodic inquiries to discover any construction.

Is the subcontractor's mechanic's lien enforceable?

No! Without service of the 20-day preliminary notice on the landlord, the subcontractor's mechanic's lien is unenforceable. The landlord, while authorizing future improvements without the need for his prior consent, did not have *actual knowledge* of the construction. [**Kim** v. **JF Enterprises** (1996) 42 CA4th 849]

## Perfecting a mechanic's lien

Contractors and subcontractors have a **constitutionally protected** right to file a mechanic's lien against property they have improved should they not be paid for labor and materials. [California Constitution, Article XIV §3]

A **mechanic's lien** entitles the contractor or subcontractor to foreclose on the job site property to recover the amount due to him and unpaid under his contract for the labor and materials he supplied. [CC §3140]

However, the mechanic's lien remedy is only available to contractors and subcontractors whose right to be paid has been *perfected*.

A general contractor's right to a mechanic's lien is **perfected** when he and the property owner enter into an agreement calling for the contractor to deliver labor or furnish material to the job site, directly himself or through subcontractors. [Calif. Civil Code §3140]

Subcontractors **perfect** their right to payment differently from general contractors since subcontractors do not enter into contracts directly with a property owner. For a subcontractor to perfect his right to enforce a mechanic's lien against the ownership of the job site by foreclosure, a *20-day preliminary notice* must be served on the appropriate parties. [CC §3097]

Before a subcontractor employed by the general contractor can record a mechanic's lien against the property and enforce it by foreclosure, he must serve a **20-day preliminary notice** on:

- the owner;
- the general contractor; and
- the construction lender. [CC §§3097(a), 3098(a)]

The **20-day preliminary notice** informs the owner of the property and the lender that the subcontractor has the right to record and foreclose a mechanic's lien against the owner's interest in the property if the subcontractor is not paid for his labor and materials. The 20-day preliminary notice is not a notice of nonpayment. Rather, it is a notice which informs the relevant parties (the owner, the general contractor and the construction lender) that the subcontractor has been or is supplying labor and materials to the property. [CC §3097(c)(1)]

In contrast to subcontractors, a general contractor who enters into an agreement with the owner does not need to provide the owner or the construction lender with a 20-day preliminary notice. [CC §3097(a), (b)]

## Preliminary notices by subcontractor

The **20-day preliminary notice** requirement applies to subcontractors in both private and public works. However, for public works, the subcontractor must serve the 20-day preliminary notice on the public agency responsible for the work. [CC §3098(a)]

The 20-day preliminary notice for private work must include:

- a description of the equipment, materials, services or work performed and an estimate of the price;
- the subcontractor's name and address;
- the name and address of the person with whom the subcontractor has contracted;
- a description of the job site location; and
- a statement of the subcontractor's lien rights. [CC §3097(c)]

The preliminary notice must be served within **20 days** after the subcontractor first furnishes labor, service, equipment or materials to the job site, commonly called *labor and materials*. [CC §§3097(d), 3098(a)]

The subcontractor who serves the preliminary notice more than 20 days after first providing labor, service, equipment or materials is barred from using the mechanic's lien for amounts of money owned for labor or supplies delivered prior to the 20 day period.

The subcontractor may only assert a claim under a mechanic's lien for nonpayment of labor and materials furnished beginning 20 days prior to service of the preliminary notice. [CC §§3097, 3098]

Further, if the subcontractor fails to serve the 20-day preliminary notice prior to recording his mechanic's lien, the mechanic's lien is invalid. Also, the subcontractor is subject to disciplinary action by the **Registrar of Contractors** for filing a mechanic's lien without first giving the 20-day preliminary notice if the subcontract exceeds $400. [CC §3097(h)]

## Locating the construction lender

A subcontractor must check the *public record* to identify the **construction lenders** he must serve with a 20-day preliminary notice before his right to be paid and later record and enforce a mechanic's lien for nonpayment is established.

Identification of the construction lender in the **public record** is accomplished by checking the county recorder's office for any construction trust deeds recorded on the job site, and the county zoning office, the City Department of Building and Safety or any other agency which makes building permit information available for public inspection.

Agencies authorized to issue building permits provide space on their building permit application forms for entry of the construction lender's name and address. [CC §3097(i)]

It must be noted in the space provided in the building permit application if the construction lender is unknown at the time the contractor applies for the permit. [CC §3097(i)]

Consider a subcontractor who checks the public record on the day he begins on-site work to identify and serve the construction lender with a **20-day preliminary notice**. A construction loan has not been recorded with the county recorder's office and a lender is not noted on the building department records.

The subcontractor serves a 20-day preliminary notice on the owner and the contractor within 20 days of commencing on-site work. The project owner then records a trust deed for a construction loan before 20 days has run since the subcontractor began work. The subcontractor is unaware of the construction loan and does not serve a notice on the construction lender.

The subcontractor is not paid when the work is completed. The subcontractor records a **mechanic's lien** for the amount unpaid and makes a demand on the construction lender to be paid.

The construction lender seeks to invalidate the mechanic's lien, claiming the subcontractor has a duty to continue checking the public records for a recorded construction trust deed until the 20-day limitation for service of a preliminary notice expires, and if he discovers the existence of a construction loan, serve the notice on the lender.

Does the subcontractor have a duty to check the public records again on the 20th day after commencing work to locate the existence of a construction lender?

No! A subcontractor does not have a duty to **recheck the public records** to establish a construction lender's identity. A subcontractor only needs to check the public records once, whether on the first day of work or at any other time during the 20-day preliminary notice period.

Since no record of the construction loan existed at the time the subcontractor checked the public record, the subcontractor does not have *constructive notice* of the construction lender's identity. Thus, he is not required to send the lender a 20-day preliminary notice before exercising his mechanic's lien rights.

**Constructive notice** of the construction lender's identity exists when the lender's name appears on the public record, either by way of a recorded construction loan trust deed or on a building permit, on the day the subcontractor checks the records after he begins onsite work. [**Kodiak Industries, Inc.** v. **Ellis** (1986) 185 CA3d 75]

However, the failure of the public record to list a construction lender's name does not relieve a subcontractor from the obligation to serve the lender with a 20-day preliminary notice if the subcontractor has *actual knowledge* of the lender's identity due to information supplied by the owner or the general contractor. [CC §3097(i)]

### Construction trust deeds

A trust deed securing a loan arranged to fund the construction of improvements on real estate must:

- be entitled *"Construction Trust Deed"*
- state the name and address of the owner (trustor) and the lender (beneficiary); and
- include a legal description of the property. [CC §3097(j)]

However, the failure of the person recording the construction trust deed to provide all of the aforementioned required information does not relieve the subcontractor of the obligation to serve the lender with the preliminary notice if the construction trust deed is on file on the first day the subcontractor begins work. [CC §3097(j)]

### Contractor's and owner's duty to inform

Contractors are also responsible for providing subcontractors with the name and address of the owner and construction lender.

If known, the construction lender's name and address must be disclosed in the original written agreement entered into by the owner and the general contractor. [CC §3097(m)]

In turn, the general contractor entering into contracts with subcontractors must include the names and addresses of the owner and the construction lender in the subcontract. [CC §3097(m)]

When a construction loan is obtained after construction has commenced, the owner, on receipt of a 20-day preliminary notice from the subcontractor, must provide the subcontractor with the name(s) and address(es) of any construction lender(s). [CC §3097(n)]

The 20-day preliminary notice statutes do not dictate what is required of a subcontractor when an owner or general contractor provides a construction lender's name and address after construction has begun and the 20-day preliminary notice has been served.

However, a prudent subcontractor should serve the construction lender with a copy of the 20-day preliminary notice when he receives the name and address of the lender after construction has begun, even if the 20-day period has lapsed. Thus, the construction lender is notified at the earliest possible moment that the subcontractor has provided labor and materials to the job site.

This lender identification process does not apply to home improvement or swimming pool contracts. [CC §3097(m)]

## Mechanic's lien recording period

A mechanic's lien, also called a *claim of lien*, is an unnotarized statement signed by the contractor or subcontractor and recorded. The lien statement in the mechanic's lien form sets out the dollar amount of the contractor's unpaid demand for labor and materials. The recording also identifies the parties and describes the property, labor and materials involved. [CC §3084]

A mechanic's lien may be recorded after the contractor/subcontractor has made a demand for payment and payment has not been tendered and received.

**Time limitations** exist for recording a mechanic's lien after *completion or cessation* of construction on the job site. Notices of completion or cessation are recorded by the owner of the property being improved to reduce the period during which the mechanic's lien must be recorded in order to be enforceable by foreclosure.

Thus, **recording a notice** of completion or cessation of labor is financially important to the owner since recording commences the time period which cuts off any further claims. A *notice of completion* may be recorded by the owner in the county where the property is located within 10 days after completion of construction. [CC §3093]

A *notice of cessation* may be recorded by the owner in the county where the property is located 30 days after cessation of all onsite labor when the project is not completed. [CC §3092]

However, if a **notice of cessation** is not recorded, a 60-day cessation of labor is **considered completion** of the construction project and commences the limitation period for recording a mechanic's lien.

Mechanic's liens must be recorded within one of two periods of time:

- when a notice of completion or cessation of labor is recorded, the mechanic's lien of a general contractor must be **recorded** within 60 days (30 days for a subcontractor) of the date the notice of completion or cessation is recorded; or
- if a notice of completion or cessation of labor is **not recorded**, all mechanic's liens must be recorded within 90 days of the date the project is completed or considered completed. [CC §§3115, 3116]

Consider a subcontractor who delivers materials to a site to be used in the construction of a building. The subcontractor is not paid for the materials.

More than 90 days after the project is completed, the subcontractor records a mechanic's lien.

After the mechanic's lien is recorded, a notice of completion is recorded which states an incorrect completion date. The completion date is erroneously stated as being within 30 days prior to the date the mechanic's lien was recorded.

To avoid the subcontractor's mechanic's lien, the owner and general contractor claim the mechanic's lien is unenforceable since it was not recorded within 90 days after the actual completion date of the building.

The subcontractor claims the mechanic's lien is enforceable since it was recorded within 30 days of the completion date stated in the notice of completion.

Is the mechanic's lien enforceable?

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

# NOTICE OF NONRESPONSIBILITY

Civil Code §3094

**DATE:**_____________, 20______, at ________________________________________________________, California.

**NOTICE IS HEREBY GIVEN:**

**1.** _________________________________________________________________ is the vested and legal owner of real property located in the County of ___________________________________, State of California, identified as:

1.1 Common address:______________________________________________________________________

1.2 Legal description:

**2.** ____________________________________________________ is:

2.1 ☐ The Buyer of the property under a purchase agreement, option or land sales contract, or

2.2 ☐ The Tenant under a lease of the property.

**3.** Within 10 days before the posting and recording of this notice, the undersigned Owner or Agent of the owner obtained knowledge that a work of improvement has commenced on the site of the property involving ☐ construction, ☐ alteration, or ☐ repair.

**4.** The Owner will not be responsible for any claim arising out of this work of improvement.

**5.** I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date:_____________, 20______ Signature:_______________________________________________

☐ Owner, or ☐ Agent of the owner.

STATE OF CALIFORNIA
COUNTY OF_____________________________________________
On ____________________________________________ before me,
______________________________________________________
*(name of notary public)*
personally appeared __________________________________
______________________________________________________,
*(name of principal)*
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.
WITNESS my hand and official seal.

Signature: ____________________________________
*(Signature of notary public)*

*(This area for official notarial seal)*

**FORM 597** 06-06 

No! When a notice of completion is not recorded within 10 days after the actual completion date, a mechanic's lien must be recorded within 90 days after the actual completion date of construction to be enforceable.

While no statute requires the owner to record a notice of completion, the notice benefits the owner by shortening the period in which a mechanic's lien may be recorded and foreclosed upon. [**Fontana Paving, Inc.** v. **Hedley Brothers, Inc.** (1995) 38 CA4th 146]

## Foreclosing the mechanic's lien

A general contractor or subcontractor who has entered into a construction contract with the owner or tenant of a job site has timely served a 20-day preliminary notice on the owner and the construction lender. The general contractor or subcontractor may record a mechanic's lien against the property if he has not been paid as agreed.

If the mechanic's lien is timely recorded, it is enforced by filing an action to *judicially foreclose* the lien on the property. The action must be filed within 90 days after the mechanic's lien is recorded. [CC §3144(a)]

On failure to file the **foreclosure action** within the 90-day period, the mechanic's lien becomes *void*, no longer binding or encumbering the property. [CC §3144(b)]

## Notice of nonresponsibility

Consider a tenant who is authorized by the landlord to make improvements on the leased premises.

If the tenant contracts for improvements and fails to pay, a mechanic's lien recorded by the unpaid contractor will attach to the tenant's leasehold interest in the property. [CC §3128]

Further, if the landlord or his property manager has *actual knowledge* of the construction, the mechanic's lien will also attach to the landlord's fee interest in the property unless the landlord records and posts a *Notice of Nonresponsibility* within 10 days after he becomes aware of the improvements. [Kim, *supra*]

A landlord who has actual knowledge a tenant is making improvements must record and post a **Notice of Nonresponsibility** to avoid the attachment of the mechanic's lien to the fee interest held by the landlord. [See Form 597 accompanying this chapter]

The Notice of Nonresponsibility is a written notice which must be **posted** in a conspicuous place on the property and **recorded** with the recorder's office in the county where the property is located within 10 days after the landlord becomes aware of the improvements. [CC §3094]

## Enforcement of rights

Consider a subcontractor who is employed by a general contractor to supply labor and materials for the improvement of a property.

The subcontractor is hired under a subcontract agreement with the general contractor which contains a *pay-when-paid provision*. The **pay-when-paid provision** states the general contractor must receive payment from the owner of the property before the general contractor is obligated to pay the subcontractor, called a *condition precedent* (to payment), or *contingency*.

The general contractor obtains a *payment bond* from a corporate surety to protect the owner from mechanic's lien claims arising due to the general contractor's failure to pay for labor and materials.

Later, the owner stops making payments to the general contractor. In turn, the general contractor stops making payments to the subcontractor since he owes the subcontractor nothing under the subcontract until he is paid by the owner.

The subcontractor records a mechanic's lien against the property and seeks recovery from the surety under the general contractor's payment bond.

The surety claims the subcontractor is not entitled to payment under the bond since the pay-when-paid provision ended the general contractor's obligation to pay when the owner ceased making payments.

Is the subcontractor entitled to payment under the surety bond issued to cover mechanic's lien claims?

Yes! The surety is liable to the subcontractor for amounts remaining unpaid since the pay-when-paid provision in the subcontract is *void*. The provision constitutes an unenforceable attempt by the general contractor to cause the subcontractor to waive his (constitutionally protected) mechanic's lien rights against the property since the subcontractor, by his agreement with the general contractor, is not entitled to compensation for unpaid work when the owner does not pay.

The *waiver* of a subcontractor's mechanic's lien rights is **unenforceable** since it is against public policy, except in limited situations authorized by statutes. [**Wm. R. Clarke Corporation** v. **Safeco Insurance Company of America** (1997) 15 C4th 882]

# Chapter 41 Clearing a lien-clouded title

*This chapter instructs a listing agent on how to negotiate the release of any judgments or state/federal income tax liens encumbering a homeowner's residence which is in foreclosure.*

## Negotiate a release to create equity

An **equity purchase** (EP) investor enters into an EP agreement to buy a seller's residence which is in foreclosure. [See **first tuesday** Form 156]

After expiration of the seller-in-foreclosure's five-day cancellation period, escrow is opened and a preliminary title report is ordered. The title report discloses an *abstract* has been recorded referencing a **money judgment** against the seller which has attached to the residence, called a *judgment lien*.

The **judgment lien** was not referenced in the purchase agreement. By the terms of the purchase agreement, the down payment may be reduced by the amount of any unmentioned lien and the responsibility for payment of the lien shifted to the EP investor. The purchase agreement makes it optional for the EP investor to take title subject to the recorded judgment lien rather than having the debt satisfied and the lien released prior to closing. [See **first tuesday** Form 156 §12.3]

Further, the title insurance company demands either a *partial* or *full release* be recorded before they will issue a policy of title insurance and eliminate any reference to the judgment lien as excluded from coverage. The EP investor chooses to have the lien released before closing, rather than opting to offset the down payment and leave the lien on the record for later negotiations for its release.

However, the seller-in-foreclosure is uninformed about **lien avoidance**. Accordingly, the seller's listing agent takes control by contacting the judgment lienholder, directly or through escrow, to negotiate a partial or full release of the lien so the purchase transaction can be closed. These negotiations are allied to those for a short payoff of a trust deed loan.

The lienholder initially demands full payment of the debt, which is the very reason he recorded his lien.

However, economic leverage exists when negotiating a lien release with the creditor since the first trust deed on the property is in foreclosure and the seller-in-foreclosure qualifies for an automatic homestead exemption. Both are senior to the judgment lienholder's rights to recover from the value in the property.

The trustee's foreclosure sale, should it take place, will wipe out the judgment lien. Also, the homestead exemption available to the head of a household protects up to $75,000 of the homeowner's equity, protecting that amount of equity from collection on the judgment.

## The lien about to be wiped out

Generally, a good bargaining tactic for obtaining a **release of a lien** from a seller's residence is a combination of:

- a "gentle reminder" that the lien is on the verge of being *wiped out by foreclosure* of the first trust deed;

- a review of the homeowner's *homestead exemption* rights as having priority to the creditor's lien;
- an *offer to pay* a lesser amount in full satisfaction of the debt owed to the lienholder; and
- a partial (or full) satisfaction and the execution of a partial (or full) release, allowing the abstract of judgment to remain of record (unless fully released) while *releasing the residence* from its lien.

The objective of the agent's negotiations is to give the lienholder sufficient incentive to cooperate and release the property from the lien. The seller's agent is in a better position to deal with the lienholder in an aggressive manner than the seller-in-foreclosure who has exhausted his goodwill with the judgment creditor.

A financially advantageous situation is created for all parties when:

- the **lienholder** collects a portion of the money owed, which is not enforceable against the residence if a foreclosure wipes out the judgment lien, or a recorded or automatic homestead exemption exists;
- the **seller-in-foreclosure** continues with the sale of the residence, avoiding the elimination of his equity by the lender's foreclosure, and receives any proceeds protected by his homestead exemption for later reinvestment in a replacement residence; and
- the **equity purchase (EP) investor** keeps his purchase agreement alive by negotiating a release of the lien from the property's title in exchange for a less-than-full payoff to the lienholder, which is paid out of the seller-in-foreclosure's proceeds from the sale.

## Release of recorded instrument

When a judgment lienholder agrees to release a residence, a signed and notarized **release of recorded instrument** must be obtained from the lienholder and recorded. All aspects of the paperwork can be handled through escrow after negotiations have been completed. [See Form 409 accompanying this chapter]

The release contains all the information necessary to clear the judgment lien from the residence's record title.

When the release is notarized and recorded, the judgment lien against the residence is removed, and a policy of title insurance is issued free of the lien.

## The abstract of judgment lien

A judgment creditor creates a valid lien on his debtor's real estate by recording an *abstract of judgment* issued by a state court. [Calif. Code of Civil Procedure §697.310(a)]

A judgment lien continues in effect for 10 years from the date it was recorded, unless the money judgment is either satisfied or released. [CCP §697.310(b)]

However, the recording of a certified copy of a judgment awarded by a federal court attaches without the recording of an abstract of judgment.

For example, a judgment creditor obtains a federal district court money judgment against an individual. A **certified copy** of the judgment is recorded in the county where the individual is the vested owner of real estate.

The owner obtains a loan secured by a trust deed on the property. A dispute between the lender and the judgment creditor arises over who has priority and is entitled to funds remaining after a payoff of the first trust deed.

The lender claims the recorded federal judgment is not a valid lien since it is not documented by a recorded abstract of judgment to give the lien priority to the lender's trust deed.

Does the judgment creditor hold a valid lien senior to the lender's trust deed?

Yes! The judgment creditor holds a valid lien senior to the lender's trust deed since a federal judgment creditor creates a lien on real estate owned by the judgment debtor on recording a **certified copy** of the federal judgment. [**In re McDonell** (9th Cir. BAP 1996) 204 BR 976]

A money judgment from a court of the United States becomes a valid lien on real estate on the recording of:

- an abstract of judgment; or
- a certified copy of the money judgment. [CCP §697.060]

### The FTB as a judgment creditor

A personal income tax lien on a residence recorded by the Franchise Tax Board (FTB) is enforced with the same procedure as any creditor's judgment lien. The FTB issues and records a *warrant* which has the same force and effect as an abstract of judgment issued by a court. [CCP §688.020]

The FTB lien created by recording the **warrant** attaches to real estate owed by the debtor in the same priority as would a judgment lien. More importantly for the debtor who is a homeowner and head of the household, the FTB lien is junior and subject to the seller-in-foreclosure's homestead exemption which shields $75,000 of his equity from seizure. [CCP §688.030; Government Code §§7170 et seq.]

Unfortunately for the seller-in-foreclosure and the equity purchase (EP) investor, no statutory or regulatory authority exists for the FTB to negotiate a partial payment of the tax bill in exchange for releasing the residence from the tax lien.

However, California's **Taxpayer Bill of Rights** provides some relief since the FTB must release its lien from the residence if the proceeds from the sale would not result in a reasonable reduction of the seller-in-foreclosure's debt to the FTB. [Calif. Revenue and Taxation Code §21016(a)(3)]

However, no case law exists testing whether the statute may be used as an offensive weapon to quiet title to real estate and eliminate the cloud of a state income tax lien.

### Releasing an IRS lien

Consider an equity purchase (EP) investor whose preliminary title report reveals the existence of a **federal tax lien** junior to a trust deed loan which is in foreclosure.

If the residence is sold at a trustee's sale, the Internal Revenue Service (IRS) may later *redeem* (purchase) the property from the successful bidder at the trustee's sale by paying the amount of his bid within 120 days, plus interest and foreclosure costs. Thus, the equity can be acquired by the IRS after the trustee's foreclosure sale to satisfy the delinquent payment of income tax. The IRS will later hold its own auction and resell the residence.

If a second trust deed exists on the residence, the IRS will typically wait until the first trust deed lender completes its foreclosure, wiping out the second and creating an equity. The IRS then steps in within 120 days after the trustee's sale and acquires the residence from the buyer at the trustee's sale.

On a regular sale of property, the IRS has the *authority to negotiate* with the seller/taxpayer (or the EP investor after closing the EP transaction) to accept partial payment in exchange for releasing the income tax lien when the IRS' recovery under its lien and redemption and resale rights would be economically unfeasible. [Internal Revenue Code §6325(b)(2)]

Thus, the release of the IRS tax lien from the property's title can be negotiated by the agent (or other authorized person) on behalf of the taxpayer by using some of the same persuasive techniques used to negotiate a release of a judgment lien with a creditor.

To release the tax lien, the **seller-in-foreclosure applies** for a discharge of the residence from the federal tax lien by submitting a written request to the district director of the IRS. Instructions and format for the request are available in IRS Publication 783 at *www.irs.gov*. [Revenue Regulations §301.6325-1(b)]

Current IRS policy dictates the IRS, not the seller-in-foreclosure, must receive all or most of any equity remaining in the residence.

Additionally, the EP investor should consider whether it is more advantageous to take the residence subject to the IRS tax lien, especially if the property is a "fixer-upper." If little or no equity exists beyond the encumbrances senior to the IRS lien, the EP investor, as the new owner, can negotiate with the IRS for the release of the lien in exchange for a small cash payment — frequently an amount less than the IRS would have been willing to accept from the seller-in-foreclosure prior to the EP investor becoming the owner.

However, taking the residence subject to the IRS lien entails a risk of loss which must be analyzed. The IRS may decide to leave its lien intact on the property, and thus participate in the future property value added by inflation, appreciation or the efforts of the EP investor. [**Han** v. **United States of America** (9th Cir. 1991) 944 F2d 526]

## The homestead exemption coup

A homeowner's equity of up to $75,000 for a head of household is protected by California homestead exemption laws. [CCP §§704.710 et seq.]

The homestead protection is **automatic** when the judgment lienholder, a creditor or the Franchise Tax Board (FTB), attempts to enforce its money judgment by a sheriff's sale of the homeowner's residence. The residence cannot be sold by the lienholder when the net proceeds of the sale will be less than the homestead exemption amount.

However, the statutory homestead exemption only applies to execution sales ordered by a court to satisfy money judgments against the homeowner and to the sale of the home in a bankruptcy proceeding.

Though merely a defensive tool for the homeowner, the **automatic homestead** exemption becomes a powerful offensive tool in a bankruptcy proceeding. Through bankruptcy proceedings, the homeowner can clear his title of judgment and state tax liens which impair the value of his homestead. [**In re Herman** (9th Cir. BAP 1990) 120 BR 127; 11 United States Code §522(f)].

However, the automatic homestead exemption is not enforceable against an Internal Revenue Service (IRS) tax lien in bankruptcy. [**U.S.** v. **Heffron** (9th Cir. 1947) 158 F2d 657; 11 USC §545]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

*SPACE ABOVE THIS LINE FOR RECORDER'S USE*

# RELEASE OF RECORDED INSTRUMENT

**DATE:**_____________, 20______, at ________________________________________________, California.

*Items left blank or unchecked are not applicable.*

**1.** From the Document entitled ________________________________________________,

**2.** Dated __________________, and recorded on __________________, as Instrument No.__________________ in the Official Records of ________________________________________County, California.

**3.** Pursuant to the judgment entered in the _________________ branch of the _________________________County _______________________________ Court, dated __________________, renewed _______________________, in a legal action entitled ________________________________________________, docket number _______________________________,

**4.** Held by________________________________________________ and against ________________________________________________,

**5.** Is hereby released:

5.1 ☐ all interests in real property situated in the County of record, owned or hereafter acquired by ________________________________________________

5.2 ☐ the real property situated in the County of record described as:

________________________________________________

________________________________________________

**THIS FORM IS NOT A RECONVEYANCE OF A TRUST DEED. DO NOT USE THIS FORM TO RECONVEY A TRUST DEED FROM RECORDED TITLE.**

Date:_____________, 20______ ____________________ (Print Name) ____________________ (Signature)

Date:_____________, 20______ ____________________ (Print Name) ____________________ (Signature)

STATE OF CALIFORNIA )
COUNTY OF ______________________________)
On ______________________________ before me,
______________________________
(name of notary public)
personally appeared ______________________________
______________________________,
(name of principal)
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature: ______________________________
(Signature of notary public)

*(This area for official notarial seal)*

**FORM 409** 10-01 

Alternatively, the homeowner may have recorded his **declaration of homestead** prior to the date a judgment or FTB lien was recorded. If the recorded homestead is senior to the judgment creditor's or FTB's lien and the net proceeds of a voluntary sale of the residence will be less than the homestead amount, the owner can quiet title to the property and eliminate the effect of the judgment or FTB tax lien on that property.

However, like the automatic homestead exemption, the recorded homestead has no priority over an IRS tax lien. Thus, the IRS can still force the sale of the residence under its tax lien. [**U.S.** v. **Rodgers** (1983) 461 US 677]

In practice, the release of an IRS lien is always negotiated based on whether or not it has recorded priority over voluntary encumbrances and judgment liens on the residence. The homestead has no effect on the **lien rights of the IRS**.

Whether it is by an automatic exemption or recorded declaration, the homestead is leverage to be used to induce judgment lienholders and the FTB to voluntarily release their lien from the title to the residence. The effects of foreclosure, a bankruptcy or quiet title action to enforce the homestead exemption and clear title gives lienholders an incentive to negotiate the release.

## Preparing the Release of Recorded Instrument

The numbers on the instructions correspond to the numbers given provisions in Form 409.

**Check** and **enter** only the items to be included as provisions in the release.

**§1. Enter** the name of the document which created the lien on the property, e.g., *abstract of money judgment.*

**§2. Enter** the date the document creating the lien was prepared, and the date and identification of its recording.

**§3.** If the document is a release of an abstract of money judgment:

- **enter** the identification of the court which entered the judgment;
- **enter** the date of the judgment and the date of any renewal;
- **enter** the title of the cause of action in the case, e.g., *breach of contract, negligent misrepresentation, unlawful detainer,* etc.; and
- **enter** the docket number the court assigned to the case. [CCP §697.370]

§4**. Enter** the names of the lienholder and seller. [Gov C §27288.1(b)]

**§5. Check** the box indicating whether the release is:

5.1 a blanket release of all recorded interests in real estate in the county. If all property is released, **enter** the name of the seller-in-foreclosure again, thus identifying him as the owner whose property interests are being released from the judgment lien; or

5.2 a partial release only for a specific property. If only a specific property is released, **enter** the legal description of the property released.

The lienholder unilaterally executes the release by **signing** it and **dating** his signature.

**Notarize** the release for recording. **Record** the release to clear the seller-in-foreclosure's title of the lien. [Gov C §27287]

# Chapter 42 — The lis pendens

*This chapter explains the use of a lis pendens and the requisite of a probably-valid claim to record a lis pendens.*

## Clouding the title with a notice

Several days into a sales escrow, a seller discovers the sales price set by the purchase agreement he entered into with the buyer is 20% below the property's current market value.

Prior to closing, the seller receives a backup offer substantially above the sales price he is under contract to receive from the existing buyer. The seller enters into a purchase agreement with his back-up buyer, contingent on the cancellation of the purchase agreement and sales escrow with the existing buyer.

To frustrate the closing of the existing escrow and induce cancellation, the seller refuses to cooperate or perform any of the conditions required to close. However, the existing buyer performs all the obligations necessary for him to close as scheduled.

The seller has no contingency provision or other justifiable excuse to cancel the purchase agreement and escrow instructions he entered into with the existing buyer. Nevertheless, the seller sends a Notice of Cancellation to escrow. Further, mutual cancellation instructions are prepared by escrow and forwarded to the buyer for signatures.

The buyer refuses to sign the cancellation instructions and makes a demand on the seller to convey the real estate under the terms of their purchase agreement and escrow instructions, which is refused by the seller.

The buyer is concerned the seller will convey the real estate to the back-up buyer who may acquire an interest in the property superior to his rights to buy the property under the new purchase agreement.

Does a legal mechanism exist for the buyer to notify all future buyers, lenders and tenants of the buyer's claim to ownership of the real estate before the seller conveys an interest in the property to them?

Yes! A *lis pendens* or Notice of Pending Action, when recorded, is notice from the buyer, called a *claimant*, warning all prospective buyers, leasees or encumbrancers who might acquire an interest in the property that **title or possession** of the real estate described in the lis pendens is in dispute. [Calif. Code of Civil Procedure §405.2]

**Lis pendens** is the latin phrase for *pending litigation*. More commonly, a lis pendens is referred to as a **Notice of Pending Action**. In this example, the pending action noticed by the recorded lis pendens is the buyer's filing of a lawsuit for the specific performance of the original purchase agreement entered into with the seller.

Persons who acquire an ownership interest, a lien or take possession to real estate after a lis pendens describing the property has been recorded, take their interest in the property subject to the claimant's right, if any, to the real estate.

## Preservation of title

The purpose of recording a **lis pendens** is to preserve a person's rights to the real estate until the dispute with the owner is resolved.

Without a recorded lis pendens or physical possession of the real estate, the person who claims an interest in title or the right to possession of the real estate, such as the buyer in our prior example, runs the risk the owner will encumber or convey the property to another buyer, lender or tenant who is unaware someone else already holds an interest in the property.

Occasionally another buyer or a lender acquires possession or a lien on the real estate before they become aware or are on notice of a dispute between the property owner and someone else (claimant) over title or possession. Then, the claimant in the dispute loses his rights to recover that interest, to the extent the interest he was to receive was conveyed to that someone else.

## Title or possession to real estate

A lawsuit must affect title or the right to possession of real estate to support the recording of a lis pendens. [CCP §405.20]

Lawsuits affecting title or possession of real estate include:

- specific performance of unclosed transactions or rescission of closed transactions [**Wilkins** v. **Oken** (1958) 157 CA2d 603];
- judicial foreclosure of a trust deed lien by a lender [**Bolton** v. **Logan** (1938) 30 CA2d 30];
- foreclosure of a mechanic's lien by a construction contractor [Calif. Civil Code §3146];
- cancellation of a grant deed or other conveyance by a prior owner;
- fraudulent conveyance to be set aside as voidable by creditors [**Hunting World, Incorporated** v. **Superior Court** (1994) 22 CA4th 67];
- evictions and suits concerning unexpired leaseholds brought by tenants or leasehold lenders;
- termination or establishment of an easement between neighboring property owners [**Kendall-Brief Company** v. **Superior Court of Orange County** (1976) 60 CA3d 462];
- government declaration that a building is uninhabitable;
- ejectment of an unlawful occupant (other than a tenant) from real estate by an owner;
- partition or sale of the real estate by a co-owner;
- quiet title;
- eminent domain actions [CCP §1250.150]; and
- divorce proceedings involving real estate.

The recording of a lis pendens is also **permitted** in the following lawsuits over real estate:

- actions by adverse possessors to determine claims to title [CC §1007];
- actions to re-establish lost land records [CCP §751.13];
- actions to determine adverse interests in any liens or clouds on real estate arising out of public improvement assessments [CCP §801.5];
- actions by purchasers or the state to quiet title to tax-deeded property [Calif. Revenue and Taxation Code §3956];
- actions by innocent improvers of real estate against owners or lenders of record [CC §1013.5(b)];

- actions on an improvement bond [Calif. Streets and Highways Code §6619]; and
- actions terminating or establishing an easement, except for a public utility easement. [CCP §405.4(b)]

### Improper use of a lis pendens

Actions in which it is **improper** to record a lis pendens include:

- suits affecting title to *personal property* located on real estate;
- foreclosure on real estate by a trustee's sale;
- actions to impress a trust on personal property being recovered;
- actions to recover attorney fees;
- actions for breach of a real estate contract when only money losses are sought;
- actions for recovery of a brokerage fee on the sale or lease of property; and
- actions against a partner, member or stockholder co-owning real estate as a partnership, limited liability company (LLC) or a corporation.

For example, a creditor of an individual who is a member of an LLC formed with others to operate a real estate venture sues the member and places a lis pendens on the real estate vested in the name of the LLC. The creditor has a specific claim against the member only and no claim against the LLC itself. However, the funds lent and sought to be recovered from the member were used to fund his contribution to the LLC.

Is the lis pendens properly recorded on the LLC's property?

No! The member's only interest in the venture is his membership in the LLC, not the real estate which is owned and vested in the name of the LLC. Further, the membership interest held by the member is personal property. [**North Coast Business Park** v. **Superior Court** (1984) 158 CA3d 858]

Additionally, a creditor's suit against a shareholder does not entitle the creditor to place a lis pendens on the corporation's real estate. A claim against the corporation does not exist even if the funds obtained by the shareholder's wrongful conduct can be traced to his contribution to the corporation.

The shareholder's interest is the stock he holds in the corporation. The real estate is owned exclusively by the corporation, an entity separate from its individual stockholders. Like the ownership interest of a member in an LLC or partnership, the interest of the shareholder in the corporation is personal property. [**Wardley Development, Inc.** v. **Superior Court** (1989) 213 CA3d 391]

Consider a county which repeals an ordinance designed to control the resale and possession of real estate for low-income buyers, affecting a large number of parcels. An individual files an action to invalidate the repeal and re-impose the county controls on these low-income designated parcels.

The individual also records a lis pendens describing all the properties in the county which could be affected by the possible outcome of the action even though none of the owners are named in the lawsuit.

Is the lis pendens proper notice to owners and buyers of a suit seeking to re-enact the county ordinance affecting an owner's right to sell his property?

No! The fact the action would affect title to the properties described in the lis pendens sometime in the future if the individual prevailed on his invalidation claim is an insufficient basis for a lis pendens when

none of the owners of the properties are named as parties to the suit. [**Moseley** v. **Superior Court** (1986) 177 CA3d 672]

## Constructive trust on improper vestee

A lis pendens may be recorded in an action to impose a *constructive trust* on real estate if funds fraudulently acquired by an individual from the claimant can be directly traced to the acquisition of the real estate by that individual.

A **constructive trust** is an involuntary, court-created trust imposed on the ownership of property presently held by an owner who acquired it through:

- fraud (force, duress, undue influence, deceit or mistake);
- accident;
- the violation of a trust or agency relationship; or
- some other wrongful act. [CC §2224]

A constructive trust is imposed on title as a remedy used to establish that a wrongdoer, who holds title to property he did not properly acquire and is not entitled to own, is an *involuntary trustee* holding title to the property for the benefit of the person entitled to the property. [CC §2224]

However, a constructive trust is not created when real estate is **improved** rather than **purchased** with fraudulently acquired money. The transfer of property by a court imposed constructive trust on the vested owner in favor of an injured party is not appropriate when the fraudulently acquired funds are used to make improvements to the real estate which are less than the overall value of the property.

Thus, recording a lis pendens on property improved by the use of fraudulently acquired funds is improper. An action seeking to impose a constructive trust on property improved by wrongfully acquired funds is essentially an action for the recovery of money, not the ownership of real estate (title) acquired by those funds. [**Burger** v. **Superior Court of Santa Clara County** (1984) 151 CA3d 1013]

## A loan unsecured is not a trust

Consider an unsecured lender who seeks to impose a **constructive trust** on real estate the owner acquired with funds advanced by the lender.

The lender files a lawsuit and records a **lis pendens** against the property to recover the money owed, claiming the owner purchased the real estate by using the lender's funds.

The owner claims the lis pendens is invalid since the underlying dispute does not concern the lender's enforcement of an unrecorded interest he presently holds in the real estate, but only the recovery of properly acquired funds used to purchase the real estate.

The lender claims the lis pendens is valid since the funds are directly traceable to the real estate and it seeks to impose a constructive trust on the property to avoid loss of the source of repayment.

Is the unsecured lender's lis pendens valid?

No! None of the claims the lender made against the owner of the real estate concern claims to possession or an interest in title to the real estate. The constructive trust was sought on the property to have it sold and provide a source of funds to repay the lender. [**Lewis** v. **Superior Court** (1994) 30 CA4th 1850]

In this example, the unsecured lender should have sought and obtained a court ordered *attachment* of the property to properly enforce the collection of his claim. Better yet, the lender should have initially obtained the owner's promise to secure the debt owed the lender by the real estate he was buying, and then perfect the promise to secure the loan by receiving and recording a trust deed as a voluntary lien on the property.

### The lis pendens process

To record a lis pendens, a lawsuit must first be filed involving *title or possession* of the real estate. [CCP §405.20]

The lis pendens must:

- identify the parties to the lawsuit; and
- give an adequate description of the real estate. [CCP §405.20]

While the object of the lawsuit and its affect on title or possession of real estate does not need to be stated in the lis pendens, the **objective** of the lawsuit must be stated in the lis pendens for it to be considered an *absolutely privileged publication*. [CC §47(b)(4)]

*Editor's note — An **absolute privilege** covers any publication during a judicial proceeding which is authorized by law, including a lis pendens. A publication made under absolute privilege bars a **slander of title** action against the person wrongfully claiming an interest in the property. [See Chapter 45]*

A technical legal description of the property subject to litigation is not required as long as the property can be sufficiently identified.

For example, a property owner files a lis pendens which describes his property as being bounded by a specific road, river, fence and surveyed line. Additionally, the description erroneously states the property is located within a specific tract of land, which it is not.

Another property owner contesting the dispute claims the lis pendens is fatally defective and must be removed from the record since the description contains an error. In this instance, the lis pendens is valid even though it contains an error since the location of the property can be ascertained by the boundary description alone. [**McLean** v. **Baldwin** (1902) 136 C 565]

However, the property's legal description which is based on metes and bounds, such as exists for a numbered lot in a recorded subdivision map, should be used to clarify the location of the property.

Now consider a lis pendens **recorded** with a county recorder by a prior owner of the property to recover money owed him by the current owner from the sale of the real estate. The lis pendens identifies real estate which the current owner is under contract to convey to a buyer, but has yet to close escrow. However, the lis pendens, while recorded, is not also **indexed** by the county recorder until after the sales escrow closes.

Later, the buyer discovers the lis pendens and seeks to expunge it from his record title. The prior owner claims the lis pendens cannot be expunged since the recording alone places the buyer on *constructive notice* of the prior owner's claim against the real estate.

The buyer claims he did not have constructive notice since the lis pendens was not indexed by the recorder until after escrow closed.

Can the lis pendens be expunged by the buyer and his title cleared of its cloud?

Yes! The buyer took title to the property free of the prior owner's previously recorded lis pendens since only a **properly indexed** lis pendens gives **constructive notice**. [Lewis, *supra*]

The reason for the indexing requirements is basic. Until a recorded document is indexed, it cannot be found by a **title search**. Thus, it would be unfair to impose constructive notice on a buyer who cannot be expected to locate the document.

## Notice by recording and indexing

A lis pendens is properly of record when it is *filed and indexed* in the county recorder's office of the county where the property is located. The lawsuit it references must involve a claim to a *right to title or possession* of the real estate described in the lis pendens. [CCP §405.20]

**Recording** and **indexing** a lis pendens is constructive notice to all persons about the existence of a dispute over title or possession of a property. Any buyer, lender or tenant who is later conveyed an interest in the property will be bound by the final resolution of the dispute.

Consider a buyer who enters into a purchase agreement and escrow instructions to acquire real estate from a seller. The seller then enters into a backup purchase agreement to sell the property to another buyer, contingent on the cancellation of the pre-existing purchase agreement and escrow instructions.

The seller then unilaterally cancels the pre-existing purchase agreement and escrow instructions. The buyer files a lawsuit to enforce the purchase agreement and records a lis pendens describing the property. The lis pendens, while recorded, is not immediately indexed by the recorder. Prior to indexing the lis pendens, the seller conveys the property to his new buyer.

The original buyer then seeks to enforce his purchase agreement with the seller against the new buyer, claiming the new buyer had constructive notice of the lis pendens when the new buyer acquired title since it was previously recorded with the county recorder.

Does recording a document, such as a lis pendens, provide constructive notice to the new buyer of the lis pendens prior to it being indexed by the recorder?

No! The original buyer cannot enforce the seller's purchase agreement against the new buyer of the property (who is a bona fide purchaser (BPF)) since a lis pendens which has been recorded but has not yet been indexed does not constitute constructive notice to the new buyer. [**Dyer** v. **Martinez** (February 23, 2007) __ CA4th __]

## Title insurers and specific performance actions

Title companies usually refuse to insure title when a lis pendens is recorded against title which involves a specific performance action. Without title insurance, buyers will not buy, lenders will not lend and tenants will not occupy the property.

However, a lis pendens in a buyer's specific performance action does not interfere with a title company insuring a lender's trust deed which secures a debt in an amount less than the price the buyer will be paying for the property. [**Behniwal** v. **Mix** (2007) 147 CA4th 621]

As a result, property subject to specific performance actions by buyers is often rendered unmarketable while the lis pendens remains in effect.

The tremendous value of the lis pendens to litigating buyers is its ability to preserve the buyer's right to purchase the property. The recording of a lis pendens often persuades a hedging seller to perform.

Accordingly, the **potential for abuse** of the lis pendens procedure to cloud title of an owner's property is readily apparent.

Further aggravating to hostile owners is the rule that a recorded lis pendens identifying a court action which actually concerns title or right of possession to real estate is an absolutely privileged communication. [CC §47(b)(4)]

A publication made under an absolute privilege bars the owner from initiating a *slander of title* action against the person who claims to hold an unrecorded interest in the property. [See Chapter 45]

### Expungement of a lis pendens

A lis pendens is sometimes improperly used to tie up real estate when the claim made is against the individual, not against an interest in his real estate.

Procedurally, a wrongfully recorded lis pendens can be removed quite quickly. [CCP §§405.30 et seq.]

Any time after a lis pendens has been recorded, anyone with an interest in the property affected may file a motion asking the court to remove the lis pendens from the record, called *expungement*.

An order **expunging** a lis pendens removes from title any restrictions sought to be imposed by the lawsuit on the transfer of the property described in the lis pendens. [CCP §405.61]

Once a lis pendens has been successfully expunged, another lis pendens may not be recorded against the property by the same person without the permission of the court. [CCP §405.36]

If the owner, or any other person with an interest in the property, contests a lis pendens which clouds title to his property, the person filing the lis pendens has to prove:

- the action affects title or the right of possession to the property described in the notice; and
- a valid claim exists on which he will **probably prevail** at trial. [Hunting World, Incorporated, *supra*]

If these two requirements are not established, the lis pendens will be ordered expunged and will no longer affect title.

### Bonds in lieu of the real estate

Banks and insurance companies frequently issue a *bond* which acts as a source of payment for a liability which may arise in the future. A **bond** is a security device to insure repayment of a debt another person may become responsible to pay.

An owner seeking the expungement of a lis pendens does not have to *post a bond* with the court as a requirement for the removal of a lis pendens if a valid claim to the real estate probably does not exist. [CCP §405.32]

Conversely, the party who recorded the lis pendens may be required to **post a bond** for the amount of money he claims he is due as a condition of maintaining the lis pendens. [CCP §405.34]

## Attorney fees with expungement

An owner who successfully defends his title by prevailing on a motion to expunge a claimant's lis pendens from the record is entitled to recover his attorney fees from the claimant, unless the claimant acted with justification. [CCP §405.38]

When a lis pendens is ordered expunged on a motion by the owner, the owner is considered the prevailing party for the purpose of recovering his attorney fees.

# Chapter 43 Liens against individuals

*This chapter explores an owner's use of a partnership or limited liability company (LLC) to avoid use of the owner's name in the vesting of title to a property.*

## Vesting to shield assets from others

A broker/owner of a high volume real estate office with several sales agents has continuous access to real estate entering the market for sale, some of which the broker occasionally acquires to own as a principal.

Due to the business activities of the sales agents employed by the broker, the broker is aware he has liability exposure for their professional errors and misconduct. Even though he has incorporated his real estate office and has errors and omissions coverage, he is the licensed broker who qualifies the corporation for its broker's license and is exposed to the most liability.

As the **designated officer** of the corporation, the broker bears the sole responsibility for the constant supervision of his sales agents. The broker manages the office and sales agents and occasionally meets with clients represented by agents under his employ.

The broker, cognizant of personally maintaining a low profile to avoid the appearance of a "deep pocket" which might trigger litigation, vests all the real estate he acquires personally in a limited liability company (LLC) he has created.

The broker's conflicting ownership interest in his brokerage office and any acquisitions handled in the office on behalf of his LLC vestings is fully disclosed to any seller or buyer with whom he or his corporate brokerage office or its sales agents have any relationship.

Later, an error occurs. The broker is faced with a potentially dangerous lawsuit arising out of a previous sales agent's misconduct while acting on behalf of the broker, unrelated to any of the broker's personal real estate acquisitions.

The broker needs assurance the pending litigation, which seeks a money judgment against him personally, will not interfere with his ability to manage, sell or lease his real estate vested in the LLC.

Will a money judgment or lien against an individual member who is an owner of an LLC interfere with the real estate vested in the LLC?

No! Only the broker's ownership interest in the LLC can ultimately be affected. Further, his interest as owner of the LLC is personal property. Thus, any liens or judgments against the broker will not affect the real estate vested in the LLC, only his ownership interest in the LLC. [Calif. Corporations Code §15671]

A lien or money judgment against an individual who is a general partner, limited partner, manager or member is unrelated to the real estate vested in either a partnership or LLC.

Only after a judicial procedure called a *charging order* is processed, can a money judgment against an individual attach to the individual's ownership interest as a member in an LLC.

*Editor's note — The remainder of this chapter discusses a partner's interest in a partnership. However, the same results apply to a member's interest in an LLC. [Corp C §§17000 et seq.]*

### Interest in the partnership property

An individual who is a partner in a partnership has no interest in the real estate owned by the partnership. A partner's ownership interest in the partnership is *personal property*. [Corp C §15671]

While a partner has no interest in any partnership property, he is entitled to his share of the partnership's operating income, sales proceeds, and assets should the partnership be dissolved. [Corp C §15653]

A partner is usually a co-owner of the partnership with other partners, whom often are family members.

### Creditors, judgments and liens

A partner in a partnership, whether general or limited, may have an outstanding debt he owes due to:

- a money judgment (i.e., lawsuit liability); or
- a local, state or federal tax lien.

Once recorded, these money judgments or liens automatically attach to any real estate **interests vested** in the individual's name or the name of his trust.

However, a money judgment against a partner which does not name the partner's partnership entity as a judgment debtor can only be satisfied by foreclosing on the partner's **ownership interest** in the partnership, not the real estate owned by the partnership.

Thus, a partnership entity remains unaffected by a lawsuit against a partner. The entity carries on its normal business activities without interference from a partner's creditor seeking to enforce its collection rights under a judgment. [Calif. Code of Civil Procedure §§708.310, 708.320]

Even if a judgment debtor is a general partner, a creditor cannot reach the assets owned by the partnership. [**Evans** v. **Galardi** (1976) 16 C3d 300]

### Charging orders to attach a share

Through a money judgment against a partner in a partnership, the partner's *ownership interest* in the partnership may be attached to satisfy the judgment. This judicial procedure involves the use of an **attachment device** called a *charging order*. [CCP §708.310]

A creditor must first locate the partnership interests held by a judgment debtor. Once discovered, the creditor must apply to the court for an order to charge the ownership interest in the partnership held by the individual partner for payment of the judgment. [Corp C §15673]

Notice of the hearing on the charging order must be given to the debtor partner and all other partners in the partnership. [CCP §708.320]

A creditor of an individual partner has two options to enforce a money judgment:

- take over the partner's interest in the limited partnership, thus becoming an assignee by judicial order of the partner's ownership interest [Corp C §15673]; or
- appoint a receiver to receive the debtor's share of the income and profits; or
- foreclose on the partner's interest in the partnership. [Corp C §16504]

If a creditor chooses to take over a partner's interest, the partnership interest can be assigned to him. However, the creditor does not become a limited partner unless all partners in the partnership consent to his inclusion as provided for in the partnership agreement. [Corp C §15674(a)]

Under a charging order, the **appointment of a receiver** is also restricted to accepting the benefit of the individual partner's interest in the partnership. The creditor acquires no greater rights than the debtor partner had under the partnership law and partnership agreement. [**Ribero** v. **Callaway** (1948) 87 CA2d 135]

A creditor with a judgment has the judicial means to go after a partner's interest only. However, the reality of obtaining an individual partner's interest may be more of a hassle than it is worth. The interest the creditor obtains from the debtor partner is a nonvoting interest which prohibits interference with the partnership activities which require a vote.

Further, if a debtor partner is the general partner, the charging order's assignment of his ownership interest in the partnership to the creditor allows a majority of the other limited partners to remove the debtor partner. [Corp C §15674(d)]

If a creditor chooses to have a receiver appointed to manage a debtor partner's interest, the receiver is empowered with court supervision to sell the partner's interest in the partnership to pay off the partner's creditor.

Additionally, a receiver may judicially foreclose on a debtor partner's interest.

## Buy-out provisions triggered

One or all of the partners in a partnership may terminate a debtor partner's interest in the partnership on the notice of a charging order without causing the partnership to be dissolved by:

- purchasing the debtor partner's interest using assets of one or more of the other partners;
- offering a buy out exchange of partnership property assets (such as a specific piece of real estate) for the debtor's interest with the consent of all partners [Corp C §16504(c)(3)]; or
- prior agreement under the terms of the *buy-out provisions* of the partnership agreement.

The **buy-out provisions** in a partnership agreement between partners is the most common method used for the elimination of a partner and his creditor. Additionally, the terms of buy-out provisions are usually advantageous to the remaining partners.

Most buy-out provisions in partnership agreements call for the termination of the attached interest held by the debtor partner.

## Fraudulent conveyances by debtors

The transfer of property by an owner of real estate to **evade a creditor** is considered fraudulent when:

- the owner actually **intends to defraud** his creditors [Calif. Civil Code §3439.04(a)]; or
- a reasonably **equivalent value** is not received by the owner in exchange for the property transferred and the owner is or will be insolvent (i.e., debts exceed assets) on the transfer. [CC §3439.05]

Any property transfer made for the purpose of avoiding creditors can be set aside or invalidated as a *fraudulent conveyance*. [CC §§3439 et seq.]

However, if the full value or a reasonably equivalent value is received by an owner for a transfer, the transaction cannot be invalidated. The creditor is then left to chase down and attach the proceeds received by the owner (debtor).

A fraudulent conveyance is indicated when an individual knows of pending litigation or claims then transfers his real estate without receiving fair value.

For example, a partnership of three partners is formed. Later, a judgment is obtained against two of the partners in their individual capacities.

A creditor obtains a charging order against the partners' individual interests in the partnership. All three partners receive notice of the proceedings.

Prior to the enforcement of the charging order, the partners act to dissolve the partnership. The two debtor partners each transfer their ownership interest to the third partner, who is unnamed in the judgment, for a minimal sum. The transfer is fraudulent since the third partner was aware of the charging order and did not pay a fair value for the transfer.

If a transfer is made by an owner without a fair exchange of value to a "buyer" who knew the transfer would diminish the creditor's claim, the "buyer" becomes liable for the creditor's losses. [**Taylor** v. **S & M Lamp Co.** (1961) 190 CA2d 700]

Thus, the fraudulent conveyance of a debtor's "wealth" beyond the reach of a creditor will be subject to disciplinary action from the court.

### Fraudulent conveyance and lis pendens

Consider a creditor who receives a money judgment against an owner of real estate vested in his name. The owner conveys his interest in the real estate by a quitclaim deed to a relative before title is liened by the creditor's abstract of judgment.

The creditor seeks to set aside the transfer as a fraudulent conveyance and records a lis pendens, which clouds the title to the property conveyed.

The relative holding title claims the lis pendens is improper and must be expunged since the fraudulent transfer claim by the creditor is an attempt to recover a money judgment, not an action affecting title to real estate.

However, the lis pendens is proper since the fraudulent transfer action concerned title to the real estate and is separate from any action to enforce the money judgment. [**Hunting World, Incorporated** v. **Superior Court** (1994) 22 CA4th 67]

### The partnership asset shield

The use of a partnership to hold real estate assets was neither designed nor intended to be employed as a place to hide an individual's personal wealth. Rather, it is a means to allow real estate vested in the partnership to remain undisturbed in the face of an individual partner's adversity.

Consider an owner who places his ownership of real estate into a partnership and receives a percentage or all of the ownership interests in the partnership for the conveyance.

In this instance, the conveyance is not fraudulent. The owner has merely exchanged his interest in the real estate for an interest in the partnership. Full value is received and no tax liability is incurred on the exchange. [Internal Revenue Code §721]

In essence, the owner has substituted his real estate vesting for a position in the partnership. The owner still owns a value equal to the equity in the real estate he transferred, only in a different form. Thus, the value of the owner's interest was not diminished since he received an equivalent value for the property. The nature of his ownership interest merely changes from one of real property to one of personal property.

However, this simple change in vesting inherently makes it more difficult to locate and attach the debtor's assets. The individual owner (debtor) on a recorded abstract of judgment is not the vested owner of any real estate.

Further, the change in vesting makes the real estate, now the asset of a partnership, much more difficult for the creditor to reach due to the charging order process. As the creditor is attempting to locate and attach the debtor's assets, the partnership can continue its business of renting, selling or encumbering the property and distributing proceeds to the judgment debtor who is now a partner in the partnership.

# Chapter 44 Automatic and declared homesteads

*This chapter distinguishes the home-equity protection available to a homeowner against creditors under a recorded declaration of homestead and an automatic homestead.*

### Home-equity shield against judgments

A homeowner is sued by a creditor for money owed on a debt. The debt is not secured by the homeowner's residence. A **money judgment** is awarded to the creditor who becomes a *judgment creditor*. The homeowner becomes a *judgment debtor*.

An **abstract of judgment** is recorded by the **judgment creditor** in the county where the homeowner's residence is located.

Can the homeowner prevent the recorded abstract from attaching as a lien against the title to his home?

No! However, the type of homestead the homeowner claims — there are two — and the amount of the homestead exemption he qualifies for — there are three — determines the homeowner's ability to:

- **voluntarily sell** the home and buy another home with the homestead amount he has in his equity; or
- bar the judgment creditor from **forcing a sale** of the home to satisfy the judgment.

### The homestead interest in title

A *homestead* is the dollar amount of the equity in a homeowner's dwelling which the homeowner qualifies to hold. The amount of the homestead held by the homeowner has priority on title over most judgment liens and some government liens.

Two types of **homestead** procedures are available to California homeowners to establish the priority of the homestead equity in their home which is exempt from execution by most involuntary lienholders:

- the *declaration of homestead*, which is recorded [Calif. Code of Civil Procedure §704.920]; and
- the *automatic homestead*, also called a *statutory homestead exemption*, which is not recorded. [CCP §704.720]

Both homestead arrangements provide the same dollar amount of home-equity protection given to all homeowners in California. However, a homeowner must record a **declaration of homestead** to receive the additional benefits available under the homestead laws allowing the homeowner the right to sell and to reinvest the dollar amount of the homestead in another home.

Neither the declared nor the automatic homestead interfere with:

- *voluntary liens* later placed on the property by the homeowner, such as trust deeds; and
- *involuntary liens* given priority to the homestead exemption under public policy legislation.

**Involuntary liens** and encumbrances which are given priority by statute and can be enforced as senior to the amount of the homestead exemption include mechanic's (contractor's) and vendor's (seller's) liens, homeowners' association (HOA) assessments, judgments for alimony or child support, real estate taxes and Internal Revenue Service (IRS) liens.

Involuntary liens which are subordinate and junior to the homestead amount include:

- Franchise Tax Board (FTB) personal income tax liens;
- Medi-Cal liens; and
- judgment creditor's liens.

## Declaring a homestead

The **recorded homestead declaration** includes:

- the name of the homeowner declaring the homestead;
- a description of the property homesteaded; and
- a statement that the declared homestead is the principal dwelling of the homeowner in which he resides on the date the homestead is recorded. [CCP §704.930(a); see Form 448 accompanying this chapter]

The declaration must be signed, notarized and recorded to take effect. [CCP §704.930]

The homestead declaration may be **signed and recorded** by any one of several individuals, including:

- the owner of the homestead;
- the owner's spouse; or
- the guardian, conservator, attorney in fact, or a person otherwise authorized to act for the owner or the owner's spouse. [CCP §704.930(b)]

An individual's personal residence which is vested in a revocable inter vivos (living) trust, or other type of title holding arrangement established for the benefit of the homeowner, can also be declared a homestead by anyone who has an interest in the property and resides there. [**Fisch, Spiegler, Ginsburg & Ladner** v. **Appel** (1992) 10 CA4th 1810]

Additionally, a declaration of homestead in no way restricts the homeowner's ability to voluntarily sell, convey or encumber his homesteaded property. [CCP §704.940]

A recorded homestead declaration does not appear in credit reports or impact the homeowner's credit reputation or ability to borrow funds. Title companies disregard recorded homestead declarations, except in litigation guarantee policies.

## Automatic and declared homesteads

An **automatic homestead** is always available on the principal dwelling occupied by the homeowner or his spouse when:

- a judgment creditor's abstract is recorded against the homeowner and attaches as a lien on the property; and
- the occupancy by the homeowner continues until a court determines the dwelling is a homestead. [CCP §704.710(c)]

The **automatic homestead exemption** applies to the equity in a real estate dwelling (and its outbuildings), a mobilehome, a condominium, a planned development, a stock cooperative or a community apartment project together with the land they rest on, as well as a houseboat or other waterborne vessel used as a dwelling. [CCP §704.710(a)]

On the other hand, a **recorded declaration of homestead** applies only to real estate dwellings. Thus, mobilehomes not established as real estate and houseboats are not protected by a recorded homestead, only the automatic homestead. Also, a leasehold interest in real estate with an unexpired term of less than two years is not protected by a recorded homestead declaration. [CCP §704.910(c)]

## Homesteaded real estate

As long as the homeowner claiming the exemption actually uses the homesteaded property as the principal residence for himself and his family, the type of real estate qualifying for a homestead includes:

- two five-room flats [**Viotti** v. **Giomi** (1964) 230 CA2d 730];
- an 18-unit apartment building where the owner occupies only one unit [**Phelps** v. **Loop** (1944) 64 CA2d 332]; and
- 523 acres of rural land with a house and water rights for the land. [**Payne** v. **Cummings** (1905) 146 C 426]

Homeowners qualify for one of three dollar amounts of **net equity** homestead protection:

- a $50,000 equity for a homeowner with no dependents;
- a $75,000 equity for a head of household; or
- a $150,000 equity for the aged or disabled. [CCP §704.730]

## Amount of equity protected

The dollar amount of whichever home equity protection a homeowner qualifies for is protected whether the homeowner relies on the automatic homestead or records a declaration of homestead.

An individual homeowner with **no dependents** other than himself qualifies for the $50,000 homestead exemption. [CCP §704.730(a)(1)]

A homeowner qualifies for the $75,000 homestead exemption as the **head of a household** by providing support for a spouse, dependent children, grandchildren, parents, grandparents or in-laws. [CCP §704.730(a)(2)]

An **aged or disabled** homeowner qualifies for the $150,000 homestead exemption if the homeowner or his spouse is:

- 65 or older;
- physically or mentally disabled; or
- 55 or older with an annual income of less than $15,000 or, if married, a combined gross annual income of no more than $20,000. [CCP §704.730(a)(3)]

Both a husband and a wife may be the declared homestead owners in the same homestead declaration when both husband and wife own an interest in the property. [CCP §704.930(a)(1)]

However, a couple's combined homestead exemption cannot exceed the exemption limit for a head of household ($75,000), unless one or both qualify as an aged or disabled person ($150,000). [CCP §704.730(b)]

Further, if both spouses are entitled to a homestead exemption, the homestead proceeds will be apportioned to each spouse according to their proportionate ownership interest in the homesteaded real estate. [CCP §704.730(b)]

## Abstract avoids homestead increases

As the legislature increases the amount of the homestead exemptions, a homeowner does not need to record a new declaration since the increased amount applies to the old declaration.

However, if an involuntary lien is recorded prior to the increase in the amount of the exemption, the amount of equity protected from the attachment is the homestead amount which was available when the lien was recorded, whether the homeowner is claiming an automatic or declared homestead. Thus, inflation or appreciation in the value of the residence may eventually create a home-equity large enough to exceed the homestead amount and provide some recovery for a judgment creditor. [**Berhanu** v. **Metzger** (1992) 12 CA4th 445]

## Combating a creditor's sale

A judgment creditor with a recorded abstract of judgment cannot force the sale of an owner's home to collect on a money judgment until a **court confirms** the owner's net equity in his home is a dollar amount greater than the amount of the owner's homestead exemption — whether the homestead is automatic or by recorded declaration. [CCP §704.740(a)]

For example, the head of a household owes $325,000 on trust deed loans encumbering his home. An unsecured creditor is awarded a money judgment against the homeowner and an abstract is recorded, attaching as a lien on title to the property.

Before the creditor can begin judicial proceedings against the equity in the home to collect on the judgment for the net proceeds of its sale, the home needs a **net value** in excess of $400,000 — the $325,000 owed on the existing trust deeds plus the $75,000 homestead exemption.

A home with a **net equity** (after transactional costs) of less than the homestead amount leaves nothing for the creditor to sell in order to collect on the judgment.

## Forced sale by court order only

The sale of a homesteaded dwelling can be forced by a creditor if a net equity exists beyond the amount of the homestead. To force the sale of a homesteaded dwelling, the creditor must first **file an application** for a judicially ordered sale, called an *execution sale*, stating under oath:

- a description of the property;
- whether a declared homestead has been recorded on the property;
- the names of the person or persons who claim the homestead;
- the amount of the homestead; and
- the dollar amounts of all liens and encumbrances recorded on the property and the names and addresses of the lienholders. [CCP §704.760]

If the homestead is declared and the creditor challenges the **validity of the declaration**, the creditor must prove the property does not qualify for a homestead.

However, if the homeowner has not recorded a declaration of homestead on the property, the homeowner must prove his residency in the dwelling qualifying the property for the automatic homestead exemption. [CCP §704.780(a)(1)]

If the execution sale of the property is ordered by the court and the bids received at the sale are insufficient to satisfy the senior liens and encumbrances, plus the homestead amount and the sales costs, the dwelling will not be ordered sold. [CCP §704.800(a)]

Additionally, a winning bid must exceed **90%** of the fair market value (FMV) of the property as set by the court. [CCP §704.800(b)]

A real estate appraiser is often appointed by the court to assist in determining the FMV of the dwelling. Compensation for the appraiser may not exceed comparable fees for similar services in the community. [CCP §704.780(d)]

If the dwelling is jointly owned by the judgment debtor/homeowner and another person as joint tenants or tenants in common, only the judgment debtor's interest in the property will be sold. [CCP §704.820(a)]

The proceeds from an execution sale of the dwelling are disbursed in the following order:

- pay all senior liens and encumbrances on the property;
- disburse the amount of the homestead equity to the homeowner;
- cover the costs of the sale;
- pay the judgment creditor's court costs; and
- pay the amount due to the creditor from the judgment. [CCP §704.850]

Any remaining proceeds from an execution sale go to the homeowner.

### "Drawing down" the homestead amount

Consider a homeowner who records a **declaration of homestead** on his principal residence which is encumbered by a trust deed. A creditor is awarded a money judgment against the homeowner and records an abstract of judgment.

Later, the homeowner records a second trust deed on the residence to secure another loan for an amount less than the dollar amount of the homestead exemption.

The homeowner defaults on the first trust deed loan and the first trust deed holder forecloses on the residence. The residence is sold at a trustee's sale on a bid in excess of the amount owed to the first trust deed holder.

The judgment lien creditor claims he is entitled to the excess funds since the judgment lien is prior in time to the later recorded second trust deed.

The second trust deed holder claims he is entitled to the remaining funds since the second trust deed lien is a voluntary encumbrance on the homeowner's equity protected by the homestead exemption, which entitles him to first recover against funds due to the homeowner under the recorded declaration of homestead exemption.

Is the second trust deed holder entitled to the excess funds?

Yes! The second trust deed holder is entitled to payment from the funds remaining after satisfaction of the first trust deed debt since the judgment creditor's **lien is subordinate** to the recorded declaration of homestead exemption. Further, the dollar amount of equity subject to the homestead exemption held by the homeowner was voluntarily encumbered by the second trust deed lien. [**Smith** v. **James A. Merrill, Inc.** (1998) 64 CA4th 94]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street
Address

City &
State

*SPACE ABOVE THIS LINE FOR RECORDER'S USE*

# DECLARATION OF HOMESTEAD

**DATE:**_____________, 20______, at_______________________________________________________, California.

*Items left blank or unchecked are not applicable.*

**1.** The name of the owner or owners of the real estate subject to this declared homestead:

______________________________________________________________________

*enter the name of the individual entitled to the Homestead exemption*

**2.** The declared homestead regards real estate situated in the City of ____________________________________,
County of ___________________________________, California, described as:

2.1 The property is more commonly referred to as:

______________________________________________________________________

enter the street address and the city

*— PAGE ONE OF TWO — FORM 448 —*

**3.** The declared homestead is the principal dwelling and now resided in as the residence of:

☐ A declared owner of the homestead;

☐ The declared owners of the homestead; or

☐ The spouse of the declared owner of the homestead.

**4.** I execute this declaration of homestead as:

☐ a declared homestead owner.

☐ the spouse of the declared homestead owner.

☐ the guardian or conservator of the person or estate of the:

☐ declared homestead owner; or

☐ spouse of the declared homestead owner.

☐ an attorney in fact for the:

☐ declared homestead owner; or

☐ spouse of the declared homestead owner.

4.1 As a guardian, conservator or attorney in fact, acting on behalf of the declared homestead owner or the spouse of the declared homestead owner, I am authorized to execute this declaration under the authority vested in me by ______________________________
*enter identification of the source of your authority*

**5.** The facts stated above are known to me to be true as of my own personal knowledge.

Date:_____________, 20______ ________________________________
(Print Name) (Signature)

Date:_____________, 20______ ________________________________
(Print Name) (Signature)

STATE OF CALIFORNIA )
COUNTY OF________________________________)
On ________________________________ before me,
________________________________
*(name of notary public)*
personally appeared ________________________________
________________________________,
*(name of principal)*
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature: ________________________________
*(Signature of notary public)*

*(This area for official notarial seal)*



## Automatic homestead as a shield

Although an **automatic homestead** exempts some or all of the equity in a homeowner's dwelling from money judgments obtained by the homeowner's creditors, use of the automatic homestead is limited to providing a **shield**, raised by the homeowner, to defend the equity in his house against a forced sale by an involuntary creditor.

For example, a homeowner claims his automatic exemption and receives funds in the amount of the homestead equity from a creditor's forced sale of the home. The homestead funds are protected from the creditor's attachment during a six-month reinvestment period. Further, an automatic homestead exemption is provided on the replacement residence to protect the reinvested funds. [CCP §704.720(b)]

*Editor's note — Although the proceeds are protected from attachment by the creditor's lien for the six-month reinvestment period, if the property purchased is in the same county where the lien is recorded, it*

*will not prevent the lien from attaching to new property (subject to the homestead exemption) the instant title is transferred into the buyer's name.*

Thus, a homeowner/debtor intending to purchase a replacement home in the same county with his protected funds will probably not be able to obtain title insurance for a new loan. Title companies will not make a determination as to whether an exemption on the new residence is valid. Also, the abstract lien will attach to the property as a lien senior in time to the new lender's trust deed, unless it is a trust deed carried back by a seller.

The best way to deal with the intervening (judgment) lien is to purchase property either subject to an existing trust deed or by creating a carryback trust deed. Carryback trust deeds have priority over any lien attaching to the title when the buyer takes title, unless the carryback note is specifically subordinated to the previously recorded abstract of judgment. [Calif. Civil Code §2898]

With the automatic homestead exemption, a homeowner who **voluntarily sells** his residence while title is clouded by a creditor's lien leaves the sales proceeds unprotected by the automatic exemption. This is not the case for a sale subject to a recorded declaration of homestead, which allows the homeowner to withdraw his homestead amount.

## The exemption in bankruptcy sales

For an individual who files a bankruptcy petition, any sale of the individual's home during the bankruptcy, whether voluntary or court ordered, is considered a **forced sale** entitled to the automatic homestead exemption. Thus, a bankruptcy petitioner who voluntarily sells his home (even if the sale is against the bankruptcy court's order) is still entitled to an automatic homestead exemption on the proceeds of the sale. [**In re Reed** (9th Cir. 1991) 940 F2d 1317]

Consider a homeowner whose home is being foreclosed on by the first trust deed lender. The homeowner did not file a declaration of homestead prior to the recording of the judgment lien against the property.

At the trustee's sale, a bid in excess of the loan leaves funds to be disbursed to the junior lienholder (the judgment creditor), since a recorded abstract of judgment against the homeowner exists.

Since **foreclosure** under a power-of-sale provision is a **voluntary sale** by private agreement entered into by the homeowner, not a forced sale which triggers the automatic homestead exemption, the automatic homestead exemption does not protect the homeowner's equity on a foreclosure sale of the residence. Thus, the homeowner whose home is lost to foreclosure exposes any excess proceeds from the trustee's sale to the creditor's lien, unless a declaration of homestead was previously recorded. [**Spencer** v. **Lowery** (1991) 235 CA3d 1636]

*Editor's note — A homeowner foreclosing on his home will receive his automatic homestead exemption if he files a bankruptcy petition before the foreclosure is completed. In a bankruptcy proceeding, all sales are considered forced sales and thus protect the dollar amount of the equity covered by the automatic exemption from the claims of involuntary creditors. [In re Reed, **supra**]*

Additionally, the creditor holding a judgment lien (a recorded abstract of judgment) can simply wait until the equity in the home increases, due to inflation, appreciation or loan reduction, and exceeds the amount of the homestead exemption, and then begin a forced sale. Thus, the homeowner who relies solely on the automatic homestead exemption to protect his equity is imprisoned in his own home since he cannot voluntarily sell and avoid the judgment lien unless he files a bankruptcy petition.

Although a sufficient net equity may not exist to allow the judgment creditor to force a sale of the home, the homeowner may not use a *quiet title action* based on an automatic homestead exemption to remove the lien, unlike a declared homestead.

## Declared homestead allows resale

A recorded declaration of homestead, in contrast to an automatic homestead exemption, allows a California homeowner to take the offensive against his creditors. The declaration of homestead allows the homeowner to use a quiet title action to **sever the liens** attached to his title.

Unlike the automatic homestead exemption, judgment liens do not attach to the exempt homestead amount under a declared homestead if the homestead declaration is recorded prior to the recording of the creditor's abstract of judgment. [CCP §704.950(a)]

Judgment liens attach to any equity exceeding the amount of the declared homestead exemption and all liens and encumbrances on the declared homestead at the time the abstract of judgment is recorded. [CCP §704.950(c)]

With prior planning, priority of the declaration can be accomplished by the homeowner. While it takes the creditor several months to obtain and record an abstract of judgment, a declaration of homestead can be prepared and recorded on readily available forms in a matter of minutes. [See Form 448 accompanying this chapter]

Once recorded, a declaration of homestead lasts until:

- the homestead owner records a declaration of **abandonment of the homestead**; or
- the homestead owner records a **new declaration** of homestead on another residence. [CCP §§704.980, 704.990]

If a homeowner whose title is clouded with a creditor's lien wishes to **sell his declared homestead**, the homeowner may either:

- negotiate a release of the lien with the creditor [See Chapter 41]; or
- clear title to the home through a quiet title action. [See Chapter 47]

## Clearing title of a lien

A *quiet title* action determines the priority of the creditor's lien and the recorded homestead on title. If the homeowner demonstrates the homestead declaration is valid and was recorded prior to the creditor's lien, the title will be cleared of the lien, provided no equity remains after the homestead amount. [Viotti, *supra*]

Creditors junior to a declared homestead where no excess equity exists realize their futility in litigation and are generally receptive to a negotiated release. Consequently, the homeowner can usually "buy" a partial (or full) release from the creditor — typically for less than the costs of a **quiet title** action. [See **first tuesday** Form 409]

After title is cleared and the homeowner sells his property, he has six months to reinvest the homestead proceeds in another home. If the proceeds are reinvested in a new residence within six months, the new residence may then be declared a homestead by recording a homestead declaration within six months after the purchase.

When the homeowner records a new homestead declaration on his replacement residence, the recording *relates back* to the time the prior homestead was recorded. This leaves no gap for the creditor's lien to gain priority over the homestead declaration on the new residence. [CCP §704.960]

If the homestead equity exemption has increased after the creditor recorded his abstract of judgment, the amount of exemption the property owner is entitled to in his **new residence** is the amount that was in effect when the abstract of judgment was recorded, not the current increased amount.

However, if the homeowner has not invested the proceeds of the sale in a new homestead after six months, and the proceeds are still in the State of California, the proceeds of the homestead sale can be attached by the judgment creditor.

An alternative to vesting title in the judgment debtor's name is to use a title holding arrangement, such as a corporate trustee or a limited liability company (LLC) created by the homeowner to hold title. Thus, the abstract of judgment against the homeowner will not automatically attach to the title.

# Chapter 45 Slander of title

*This chapter reviews the conditions which allow a property owner to recover for slander of his title.*

## False statements, oral or written

Slander of title refers to both slander and libel. Any interest in real estate can be harmed or damaged by false **oral statements**, called *slander*, or false **written statements**, called *libel*. [Restatement of the Law Second, Torts §624]

For a person to be liable for **slander of title** based on his comments about another person's interest in a parcel of real estate, the oral or written statement must:

- be published;
- be untrue and disparaging to the owner's property interest;
- be made without privilege; and
- cause money losses. [Rest.2d Torts §624]

A real estate interest is **slandered** when a person makes an *unprivileged false statement* about a real estate interest which brings into question the right or title to the interest, called *disparagement*, and causes the owner of the real estate interest to lose money.

A **false statement** consists of writings, words or conduct communicated to another, called *published*, which adversely affects the desirability of a **marketable interest** in real estate.

For example, a business owner places his business on the market for sale. The lease on the premises occupied by the business owner is assignable without prohibition or restriction.

The lease contains an option to renew or extend the lease. The option needs to be exercised to assure potential buyers the business can remain in possession of the premises since the location contributes to the goodwill value of the business.

However, the landlord informs the business owner he expects him to vacate the property when the original term of the lease expires. Regardless, the business owner timely exercises the option to renew/extend the lease.

A buyer for the business is located and escrow is opened. The landlord contacts the buyer and orally advises him that the business owner's attempt to exercise the renewal option was ineffective and the landlord will sue and physically retake possession of the premises if the buyer accepts an assignment of the lease and occupies the premises.

The landlord's oral statements cause the buyer to cancel the purchase agreement and escrow. The business owner has lost his buyer and the monies he would receive from the sale. Further, the landlord continues to interfere with the business owner's marketing of the business, making the sale virtually impossible by causing the value of the leasehold interest to be uncertain.

Has the landlord slandered title to the business owner's leasehold interest in the real estate occupied by the business?

Yes! The landlord's *oral misrepresentations* about the validity of the exercise of the renewal option was a publication made to a buyer who acted on the information to the financial detriment of the business owner — by **placing a reduced value** on the leasehold interest to be assigned to the buyer as a business asset. Thus, the **landlord is liable** to the business owner for the loss in the value of the leasehold caused by the disparaging remarks made to the prospective buyer. [**Baker** v. **Kale** (1947) 83 CA2d 89]

Examples of written **publications** constituting slander of title include:

- forging a trust deed which is recorded as a lien on real estate [**Forte** v. **Nolfi** (1972) 25 CA3d 656]; and
- conveying real estate by a deed without possessing a claim to title. [**Cavin Memorial Corporation** v. **Requa** (1970) 5 CA3d 345]

## Real estate interests open to slander

**Slander of title** applies to any marketable interest in real estate which is assignable, transferable or capable of being sold. A real estate interest includes the fee simple, a leasehold, an easement and covenants, conditions and restrictions (CC&Rs) — not just the vested title. [Rest.2d Torts §624]

For example, an owner and his neighbor have owned adjacent parcels of real estate for over 20 years.

The previous owner of the two adjacent parcels reserved the rear 43 feet of both parcels for road and utility purposes when he sold and conveyed the separate properties to the current owner and his neighbor. The portion reserved as a roadway was never used by the previous owner for the purposes stated in the reservation.

Both the current owner and his neighbor have always believed their actual boundaries included the reserved roadway parcels.

The owner builds his personal residence on his parcel, encroaching on the reserved parcel to the rear of his parcel. The neighbor openly uses his and the reserved parcel to the rear of his parcel and pays the property taxes on the parcel reserved from his title.

However, the neighbor does not file a judicial action to establish record title to the reserved parcel to the rear of his parcel.

The owner whose residence encroaches on the reserved parcel lists his parcel for sale.

The owner's broker obtains a property profile report from a title company and discovers the reserved parcels are not vested in the name of the owner or the neighbor. An argument about the ownership of both reserved parcels ensues between the owner's broker and the neighbor regarding the neighbor's claim of ownership by adverse possession to the reserved parcel at the rear of his parcel.

The broker arranges for the owner to purchase both reserved roadway parcels located to the rear of both properties. The owner's parcel and both roadway parcels are then acquired by a buyer. The buyer is not advised of the neighbor's claims of title by adverse possession to one of the reserved parcels.

After closing, the neighbor seeks money losses from the broker for **slander of title** regarding ownership of the reserved parcel he has been occupying. Further, the neighbor files an adverse possession action against the buyer to quiet title to that parcel.

The broker claims he did not slander the neighbor's title since a claim of adverse possession is not a property interest which can be slandered.

Can the broker slander title which is to be perfected by adverse possession?

No! The broker cannot be held liable for slander of title since he arranged the sale of the property as reflected by its recorded title. The neighbor did not hold legal title to the reservation at the rear of his parcel at the time of the broker's actions. The neighbor must first complete a judicial proceeding to **establish record title by adverse possession** before his interest can be slandered.

The intent of the policy which permits an owner to bring a slander of title action is to **protect the marketability** of his title for a potential sale of property. Title acquired by adverse possession is not marketable until the title is established by judicial proceedings against the record owner, which in this example was the buyer.

The broker did not interfere with the neighbor's ability to sell the reserved parcel he claims to own since the neighbor did not have marketable title to the property when the broker sold it. [**Howard** v. **Schaniel** (1980) 113 CA3d 256]

*Editor's note — The broker is required to indemnify the buyer for the costs of quieting title since the broker failed to disclose to the buyer a condition of title known to him — the neighbor's unrecorded claim to the property by adverse possession*.

**Privileged statements are not slander**

A statement made about a real estate interest as part of a *privileged publication* does not subject the person making the statements to liability for slander of title.

Two types of **privileges** exist:

- *conditional privilege*; and
- *absolute privilege*.

A **conditional privilege** is a defense, used by the person who made a statement, to defeat an owner's claim his title was slandered by the statement. A statement made to another person about an owner's interest is a communication legally called a *publication*. To be a **privileged publication** and thus avoid liability, the statement about the owner's interest in the real estate must be made **without malice** towards the owner of the interest. [Calif. Civil Code §47(c)]

A conditionally privileged communication includes the content of a lawsuit filed in good faith, or a dispute over a right or interest in real estate, such as a claim of ownership by way of a prescriptive easement.

**Malice**, as required to impose liability as a breach of good faith, can be:

- *actual*; or
- *implied*.

**Actual malice**, also called *malice in fact*, may be shown by the lack of justification for a person's communication when the person acts with ill will and the desire to do harm to the owner of the slandered interest. Actual malice exists when a statement adverse to an owner's interest is made solely for the purpose of causing harm to the owner.

While the existence of malice is essential for the owner to overcome the defense of a conditional privilege asserted by the individual making the injurious statement, actual malice is not required for the owner to prove his title has been slandered. **Implied** malice will suffice.

Malice may be **implied** from the conduct of the person making a disparaging statement if he is not acting in *good faith*, also called *malice in law*. Malice is inferred from the actions of an individual who is attempting to establish an invalid claim against an owner's title.

Thus, if the individual who slanders title can show his statement was made in **good faith** by showing he honestly believed his **claim of title** to be valid, then the individual cannot be held liable for slander of title when he fails to prove his claim.

For example, an owner executes a note in favor of a private lender secured by a trust deed on the owner's real estate. Later, a bank makes the owner a loan secured by a trust deed on the same property. The title insurance company erroneously insures the priority of the bank's trust deed as senior to the private lender's trust deed.

Later, the private lender attempts to foreclose as the senior lienholder. A dispute in priority between the private lender and the bank ensues. The private lender's trust deed is declared to be senior to the bank's trust deed.

The private lender initiates a slander of title action against the title company. The private lender seeks to collect his out-of-pocket money losses caused by the delay in foreclosure and a decline in the value of the security caused by the uncertainty of his trust deed's priority resulting from the erroneous priorities stated in the title insurance policy issued to the bank.

The private lender is unable to show the title company acted maliciously towards him when they issued the title policy.

Is the title insurance company liable to the private lender for slander of title?

No! The title insurance company's policy issued to the bank is *conditionally privileged*. The private lender cannot prove malice toward him exists on the part of the title company based on the erroneous priority of trust deeds in the policy of title insurance.

Additionally, a title insurance policy does not constitute a publication. A title insurance policy is not an abstract of title and does not warrant that conditions or defects in title do not exist. Under a title insurance policy, the title company only assumes the risk of the insured's money losses due to an undisclosed defect in title or error. [**Smith** v. **Commonwealth Land Title Insurance Company** (1986) 177 CA3d 625]

## Absolute privilege

A publication which falls under an *absolute privilege* bars a slander of title action, even if the publication is made with actual malice.

A communication protected as an **absolute privilege** is any statement made as part of a legislative, judicial or other *official proceeding* authorized by law. [CC §47(b)]

For example, a creditor brings an action seeking to recover money from an owner and the imposition of a lien on the owner's property. The creditor records a **lis pendens** which clouds title to the owner's property.

The creditor does not prevail in the action and the owner's title is cleared of the lis pendens. The owner then files a slander of title action seeking to recover money losses he incurred due to the creditor's recording of the lis pendens.

The creditor claims the recordation of the lis pendens is absolutely privileged, barring the owner from any recovery in a slander of title action.

The owner claims the lis pendens is not absolutely privileged since it was not **made in a judicial proceeding**, such as pleadings and communications of the judge, parties, witnesses, etc.

Is the recording of the lis pendens absolutely privileged?

Yes! A recorded lis pendens which identifies a court action concerning adverse claims against title or right of possession to the owner's real estate is an **absolutely privileged publication**. [CC §47(b)(4)]

To be a properly recorded **lis pendens**, the recorded statement must identify all parties to the lawsuit and give an adequate description of the real estate. The object of the lawsuit, whether it is title or possession, does not need to be stated in the lis pendens. [Calif. Code of Civil Procedure §405.20]

Absolute privilege applies to any publication required by law **in the course of a judicial proceeding** to achieve the objectives of a final judgment in the litigation, even if the publication is made outside the courtroom, as is a lis pendens. [CC §47(b)]

Additionally, papers filed during court proceedings are absolutely privileged from a slander of title action. Absolute privilege applies to the recording of a lis pendens since its use is authorized to give constructive notice of a **claim against property** asserted in pending litigation. [**Albertson** v. **Raboff** (1956) 46 C2d 375]

## Loss of privilege for lis pendens

However, a lis pendens losses its status as absolutely privileged if the litigation referenced does not state a claim to title or possession of the real estate described in the lis pendens.

For example, a buyer purchases property at a sheriff's sale which is in foreclosure on a money judgment an unsecured creditor was awarded in a debt collection action. The buyer intends to renovate and sell the property at a profit.

The prior owner who was wiped out by the sheriff's sale records a lis pendens against the property, referencing the debt collection lawsuit which resulted in a money judgment and the sheriff's sale and is now on appeal. The lis pendens remains of record and prevents the buyer from selling the property for three years, during which time it drops in value.

The buyer seeks to recover his loss of value from the prior owner, claiming he was prevented from selling the property since the lis pendens slandered title to his property. The prior owner claims a slander of title did not occur since the recordings of the lis pendens were absolutely privileged.

Are the recordings of the lis pendens absolutely privileged?

No! The buyer is able to recover his money losses caused by the recorded lis pendens. Here, the lis pendens were improper and lost their status as absolutely privileged. The lis pendens referenced and related to the creditor's collection effort on an unsecured debt, a lawsuit which contained no claim against the **title or possession** of the property, only to the creditor's entitlement to a **money judgment** for a debt owed. [**Palmer** v. **Zaklama** (2003) 109 CA4th 1367]

*Editor's note — The remedy for an improperly recorded lis pendens is to have the lis pendens expunged as lacking a real estate claim or evidence to support a real estate claim, and collect damages caused by*

*the recording of the lis pendens or proceed with a malicious prosecution action. [CCP §405.30; Calif. Penal Code §1447]*

## Wrongful levy issued by a court

Consider a creditor who is awarded a judgment against an individual, called a *judgment debtor*. Later, the **judgment debtor** marries an individual who is the vested owner of real estate.

After the marriage, the creditor records a **writ of execution** issued by the court as a levy on all real estate vested in the owner's name, even though it is not vested in the debtor's name. The levy **attaches as a lien** on the owner's separate property.

The owner locates a ready, willing and able buyer who enters into an agreement to purchase the property. However, the buyer refuses to complete the transaction when he (and his title insurer) learn of the creditor's levy. The property's marketability and value drops as a result of the creditor's levy.

The property owner demands the creditor's levy under the writ of execution be removed, informing the creditor:

- the judgment debtor, who is the owner's spouse, does not have an interest in the property; and
- the property owner is not a party to the action creating the judgment.

The creditor refuses to remove the lien claiming married individuals are responsible for each other's debts.

The property owner sues the creditor for slander of title to collect his money losses caused by the creditor's levy, claiming the lien was improperly placed on his real estate.

The creditor claims the recording of the writ of execution (which is the levy) is an absolutely privileged publication, performed as part of a **judicial proceeding**.

Is the court ordered levy a privileged publication?

No! The levy on the property under the writ of execution was not obtained in good faith by the creditor. The creditor held **no honest belief** the judgment debtor had an interest in the property of the owner. Thus, the creditor is liable for the owner's out-of-pocket money losses caused by his slander of the owner's title resulting from the recording of a levy in the name of the owner, a person against whom the creditor had no judgment. [**Gudger** v. **Manton** (1943) 21 C2d 537]

## Money losses due to slander of title

To impose liability, an individual's slanderous statements about title or possession do not need to be made for the purpose of directly influencing another person's conduct.

The individual making a disparaging statement is liable for an owner's losses if it is *reasonably foreseeable* his statement will be relied upon by another person, whose *reliance* will cause the owner to suffer out-of-pocket **money losses**. [Rest.2d Torts §623A, Comment b]

Thus, if the owner does not suffer out-of-pocket money losses due to the disparaging remarks, no basis exists for a claim of slander of title since nothing is to be recovered.

For example, a buyer and seller enter into a purchase agreement and open escrow. A neighboring owner makes statements to the buyer concerning a possible defect in the property's soil condition.

The seller assures the buyer the neighbor's statements are untrue, and the buyer closes escrow. The seller incurs no money damages as a result of the neighbor's statements, only minor aggravation and lost time.

Later, the seller claims the neighbor's statements slandered his title.

However, the seller has no claim against the neighbor for slander of title. The neighbor's statements, while erroneous, did not prevent the sale of the property at its full market value and the seller did not suffer any out-of-pocket money losses. [**Burkett** v. **Griffith** (1891) 90 C 532]

However, it is possible for an individual's statements to cause an owner to lose money, even if a sale is not involved.

For example, the money losses recoverable by an owner or tenant for slander of title include:

- money losses which are a direct result of another person's statement, including any decrease in the market value of the real estate caused by the slanderous statement [Rest.2d Torts §633(1)(a)]; and
- expenses incurred by the owner to remove any doubt caused by the slanderous statement, including the costs of litigation. [Rest.2d Torts §633(1)(b)]

### Punitive damages for known falsehoods

If an owner can show the slanderous statement of an individual was made with **actual malice**, *punitive damages* can be recovered from the individual slandering the owner's title. [CC §3294]

For example, to improve his residence, an owner intends to remove an existing privacy fence constructed by the prior owner and relocate it on the boundary line, which is located six feet into what the neighbor now uses as part of his backyard. Both the owner and the neighbor are aware the fence is for privacy purposes and was not built to establish an agreed-to boundary.

Further, an existing utility pole must be relocated to the boundary line which is also the center of an easement held by the utility company. The owner takes out his building permits to relocate the fence and the utility company is requested to move the pole.

The neighbor is notified of the owner's construction plans to relocate:

- the privacy fence to the boundary line; and
- the utility pole to the center of the utility easement.

The neighbor does not want the fence or the utility pole to be moved and intends to prevent the construction by asserting a boundary line dispute. The neighbor notifies the owner and the utility company in writing that he considers the privacy fence to be the property's agreed-to boundary line — a statement the neighbor knows is false.

The utility company refuses to proceed with the relocation of the utility pole until the dispute with the neighbor over the boundary line is resolved. As a result of the neighbor's actions, construction is delayed and the owner's construction costs to improve his residence are increased.

The owner sues the neighbor to establish the fence as a privacy fence and not an agreed-to boundary fence. The owner also makes a demand on the neighbor for payment of increased construction costs, claiming they are the result of the neighbor **slandering his title** and delaying the construction of the improvements.

Has the neighbor slandered the owner's real estate title?

Yes! The neighbor made statements about the owner's real estate which he **knew to be false**, causing the owner to lose money and incur expenses. The neighbor knew the privacy fence was not the agreed-to boundary yet tried to enforce it as the boundary line by interfering with the construction. Thus, the neighbor is liable for:

- the owner's increased construction costs; and
- punitive damages for slandering the owner's title. [**Appel** v. **Burman** (1984) 159 CA3d 1209]

*Editor's note — If the neighbor filed an action to dispute the boundary line instead of making the comments to the owner and the utility company, the neighbor would still have slandered the title. Any lawsuit the neighbor initiated would not be absolutely privileged since it would not be brought in good faith to protect his interest in another's property since he lacks evidence of a merit-worthy claim.*

# Chapter 46 Forcing co-owners out

*This chapter applies the involuntary partition or sale of real estate to resolve disputes between vested co-owners.*

## Divide, sell or buy out

On the death of both parents, the surviving children receive real estate vested in their names as co-owners. One child is selected to manage the property on behalf of all the children.

Soon, the children disagree on the ownership and management of the inherited property. One child, concerned about his personal liability exposure from ownership, wants the property to be sold and the proceeds distributed based on each child's percentage of co-ownership.

Another child wants to subdivide the real estate and eliminate the co-ownership by conveying the separate parcels to one another. Each child would then be the sole owner and manager of his separately divided ownership of their parcel.

Yet another child is willing to cash out the other family members and acquire ownership of the entire property himself.

Thus, no arrangement will meet the individual goals of each child vested as a co-owner.

Can any one of the co-owners force a termination of the co-ownership since they no longer agree on the ownership and management of their real estate?

Yes! A *partition action* severs co-ownership of real estate by either:

- dividing the property into parcels and **distributing it in kind** among the co-owners, if feasible [Calif. Code of Civil Procedure §§873.210 et seq.]; or
- **selling and distributing** the net sales proceeds to the co-owners according to their percentage of ownership. [CCP §§873.510 et seq.]

With a **partition action**, the co-owner wanting to be cashed out would achieve his goal, directly by a sale of the whole or later by a sale on his receipt of his divided interest. Also, the co-owner wanting to buy out the other co-owners could achieve his goal by **bidding on the property** at the court ordered sale, unless the property is partitioned, in which case the third co-owner directly obtains his goal.

## The quieting of quarreling co-owners

A **partition action** is a lawsuit to **sever** or **sell** real estate which is co-owned. [CCP §872.020]

The need for a partition action arises when co-owners cannot agree on the management, division or sale of the real estate they jointly own. Co-owners can mutually agree to divide the real estate in a **voluntary partition** or sell it as provided in most written co-ownership agreements.

Conversely, a partition action will force a division or sale of the real estate in an **involuntary division or sale** of the property.

## Who can partition

A partition action is an *equitable* remedy which has its roots in English common law, called *chancery*. The court of equity — **chancery** — has great discretion in deciding what is the best resolution for feuding co-owners.

While partition and distribution of the property is the preferred equitable result, not all forms of co-ownership or types of property allow for a partition to terminate a co-ownership.

**Nonmarried co-owners** vested as joint tenants or tenants in common have an absolute right to partition (or sell) the real estate owned. [**Lazzarevich** v. **Lazzarevich** (1952) 39 C2d 48]

A partition action is available to nonmarried joint tenants or tenants in common who take title in their individual names, acquiring title either under an agreement between themselves or by *operation of law*, such as by a will or trust.

For example, a lender makes a loan secured by the fractional interest of a co-owner in real estate. The co-owner defaults on the loan. The lender forecloses and becomes a tenant in common with the other co-owner of the property. Here, the lender acquires a fractional ownership interest in the real estate, not the entire ownership.

Can the lender, as a fractional owner, sue the co-owner for partition or sale of the real estate simply to liquidate and recover his original investment in the loan?

Yes! The lender, now owning an **undivided fractional interest** in the real estate, can sue for partition or sale to complete the liquidation of his initial security interest in the property. [**Kane** v. **Huntley Financial** (1983) 146 CA3d 1092]

## Husband/wife co-ownerships

Husbands and wives who vest title as community property are not entitled to sue for partition of the real estate owned by the community. [CCP §872.210(b)]

Further, real estate acquired after marriage and vested as joint tenants is presumed to be community property. If the property belongs to the community, a partition action is not permitted to divide and sever the ownership. [Calif. Family Code §2581]

However, real estate vested in a joint tenancy by a husband and wife can be separate property, thus rebutting the community property presumption, if either:

- a statement in the deed notes the real estate is not community property; or
- a separate written agreement states the real estate is not community property. [Fam C §2581]

Lawsuits between spouses to sever community property interests in real estate may not be brought by partition. Rather, they must be brought as part of divorce proceedings, called a *dissolution*. Consequently, the termination of a co-ownership of community real estate is subject to offsets and payment of monies to equal out the distribution of all assets of the community on **dissolution**.

*Editor's note — Under a joint tenancy vesting, a deceased spouse's entire interest in the real estate passes to the surviving co-owner without the necessity of a probate order conveying title. [Calif. Civil Code §683]*

Consider a couple who acquires real estate in a joint tenancy vesting as single or unmarried individuals before they are married.

The couple marry but do not alter the joint tenancy vesting nor enter into a written agreement transmuting the ownership into community property. Later, the couple divorce and cannot agree on the division or sale of the real estate.

Is the real estate community property?

No! Their ownership of the property is vested as joint tenants without a reference to their status as husband and wife. They were not married when they acquired title, and the vesting was not later altered by a writing (deed) to transmute their separate interests to community property. [**In re Marriage of Leversee** (1984) 156 CA3d 891]

Are the joint tenancy interests acquired before marriage severed by a partition action rather than by divorce proceedings?

Yes! Husbands and wives who vest title as joint tenants are entitled to a partition action if their co-ownership is held in a joint tenancy (or tenancy in common) vesting and the presumption of community property is rebutted by showing their interests are separate property. [CCP §872.210(b)]

### Co-owners as partners

Consider co-owners who acquire real estate and vest title in the name of a limited liability company (LLC), each owning a fractional interest in the LLC as members. The LLC, not the individual members, owns the real estate.

When the members agree to dissolve their co-ownership, the relationship is mutually terminated by a dissolution of the LLC and an accounting of the LLC's assets.

Generally, **LLC's assets** are sold as part of the accounting, *not partitioned* and distributed. The sale proceeds are then distributed to the members. However, members can agree in the LLC operating agreement to a distribution of the LLC property to the individual members as a manner of returning their capital contributions. The distribution is called a *distribution in kind*.

In another example, several members in an LLC sign an operating agreement to own several parcels of land as a farm. Under the agreement, a member can resign and call for a conveyance of separate parcels to each individual member, which one member does.

Another member claims an LLC cannot distribute property it owns to the members *in kind*, but must sell the properties and distribute the proceeds pro rata, based on the percentage of ownership each member has in the LLC.

Can a dissolution of an LLC be completed by the division of the LLC real estate between the members as opposed to only a cash distribution?

Yes! While the general rule requires the sale of LLC assets and the net sales proceeds to be distributed, the members can enforce an agreement to divide or **partition the real estate**. [**Logoluso** v. **Logoluso** (1965) 233 CA2d 523]

Additionally, a court can dissolve an LLC and distribute its assets in kind whenever the distribution would be fair and would not impair the payment of LLC debts. [CCP §872.730]

For example, four investors enter into an LLC operating agreement to buy and operate a hotel. Title to the hotel is vested in the name of the LLC. The LLC agreement does not reference the division of the property on a dissolution of the LLC.

One of the members resigns and the LLC is dissolved. The remaining members demand the LLC's real estate be partitioned and distributed in kind.

Is a partition of the LLC assets proper in this case?

No! In this instance, there is only one LLC asset (the hotel) which would normally be impractical to subdivide, unless a condominium conversion would be practical. [**Jacoby** v. **Feldman** (1978) 81 CA3d 432]

### Distribution of an LLC's assets

The ability of a member in a limited liability company (LLC) to demand a partition of LLC property is controlled by the buy out and dissolution provisions in the operating agreement.

Ordinarily, a member cannot be forced to receive part of the real estate owned by the LLC as a return of his contribution for his membership interest on dissolution of the LLC. [Calif. Corporations Code §15636(e)]

Additionally, without an agreement, no member has the right during the life of the LLC to receive any LLC asset other than money. [Corp C §15636(d)]

On *dissolution and winding up* of the LLC's affairs, the distribution to members will generally be made from the net **proceeds of a sale** of the assets.

### What real estate is partitionable?

The real estate interests which are subject to a partition suit include:

- *fee estates*;
- *life estates*; and
- *leasehold estates*. [CCP §872.210(a)(2)]

Other real estate interests, such as *easements* or *profits a prendre*, cannot be partitioned. [**Porto** v. **Vosti** (1955) 136 CA2d 395]

### Physical division preferred

A brother and sister own two adjacent parcels of unimproved land which they use for personal and recreational hunting and fishing. Title to the real estate is vested as tenants in common, each co-owner holding an undivided one-half interest. Both parcels are of equal value.

One parcel contains the actual hunting and fishing areas while the other provides access. Both co-owners use the property frequently.

The sister dies and passes her interest in the real estate to a hunting and fishing group who wish to open the real estate to the public. The hunting and fishing group offers to buy out the surviving co-owner's interest, but he refuses and files a partition action seeking to divide the property and become the sole owner of one of the parcels.

The group wants to buy out the co-owner on a sale of the property to permit members of the group to have exclusive access to the recreational areas claiming the real estate cannot be severed due to topographical problems.

The brother, as co-owner, claims he has a right to retain physical possession of a portion of the land since the land can be divided into separate parcels and the division would not reduce the economic value of the separate parcels.

Is a co-owner entitled to retain possession of a portion of the real estate if the property can be as a practical matter divided among the co-owners?

Yes! A division of the real estate is required of **tenants in common** unless it is impractical to divide and distribute or a sale of the entire real estate is fairer to all involved. [**Butte Creek Island Ranch** v. **Crim** (1982) 136 CA3d 360]

**Impractical division**

Consider two co-owners who inherit an inside lot in the middle of a densely populated area of a major city.

The lot is small (one-eighth of an acre) and is improved with residential structures — one facing the street, the other facing a back alley. The positions of the buildings on the lot do not permit a division (parceling) of the real estate or the construction of a partition wall.

Additionally, local **zoning restrictions** do not permit the further subdivision of the lot.

Is a sale of the real estate the best solution?

Yes! The further division of the lot is highly impractical and legally impossible without great loss of value to the co-owners. [**Priddel** v. **Shankie** (1945) 69 CA2d 319]

Similarly, consider the co-owners of real estate who operate a large, diverse enterprise on the property (e.g., a movie studio). The co-owners by agreement coordinate the use of the buildings, sets and lots for their own separate ventures.

Eventually, the co-owners can no longer agree on how to use the property. Due to the **location of the buildings**, a division of the property by partition is highly impractical. In this scenario, a sale of the property is the most practical remedy. [**Formosa Corp** v. **Rogers** (1951) 108 CA2d 397]

## The partition action and lis pendens

To initiate a **partition action**, a co-owner must file a lawsuit stating his interest in the real estate and the facts which establish his right to maintain a partition suit.

Specifically, a partition action must include:

- a description of the real estate;
- the interest of the co-owner;
- all other recorded real estate interests or unrecorded interests actually known or reasonably discoverable;
- the real estate interest sought to be partitioned (fee, leasehold, minerals, etc.); and
- any facts justifying the sale of the real estate. [CCP §872.230]

Once the partition action is filed, the co-owner seeking partition must record a *lis pendens* (notice of pending legal action) with the county recorder identifying the parties and the real estate involved. [CCP §872.250(a)]

The **lis pendens** is notice to all future buyers, lenders or tenants that a dispute exists regarding *title* or *possession* to the real estate. Through the recorded lis pendens, any person later acquiring an interest in or encumbering the real estate takes the real estate interest subject to the pending partition action.

### Determining real estate interests

The first procedure in a partition action is to establish each co-owner's interest in a parcel of real estate. [CCP §872.610]

The condition of the real estate's title is determined next, primarily by use of a title company's **litigation guarantee**, an insurance policy issued based on their search of the record title. [CCP §872.620]

The priority of all liens on the property is then set. Provisions will be made for the liens to be paid or assumed before the partition action can be completed or the sale proceeds distributed. [CCP §872.630(a)]

Typically, a real estate broker or attorney experienced in real estate matters is appointed as a *referee* to wade through the facts presented by the co-owners. The **referee** is an advisor to the court on the feasibility of the partition or sale. [CCP §872.630(b)]

### Cutting up the real estate

An appointed referee's activities are subject to judicial review and approval. The referee's job is to balance the competing interests and arrive at a *reasonable division* of the property between the co-owners. [CCP §873.210]

The referee must consider:

- improvements made to the property [CCP §873.220];
- the size and number of lots owned [CCP §873.240]; and
- any liens on the real estate. [CCP §873.260]

The referee determines how the property is to be divided and prepares a report for the court's review and approval. [CCP §873.280]

The report can be contested by the owners. [CCP §873.290]

### Division of the real estate

The objective in a partition action is to **physically divide ownership** and possession of the real estate between the co-owners in a practical way. The real estate can be divided in a number of ways:

- by separate lots or parcels [CCP §873.230]; or
- by allocating any improved real estate to the co-owner who constructed the improvements. [CCP §873.220]

When the real estate cannot be **divided equally**, one co-owner can be ordered to pay money to the other to even up the division. The money paid to even the distribution is legally called *owelty*. [CCP §873.250]

Any division of the real estate must comply with all environmental, zoning and other ordinances affecting the use of the real estate.

### Sale of the real estate

The sale of real estate can be held at a public auction or by a privately negotiated sale, depending on:

- which is likely to bring more money for the co-owners [CCP §873.520]; or
- a prior agreement between the co-owners. [CCP §873.600]

A court-appointed referee, such as a listing broker, is given great latitude to conduct sales. For example, real estate consisting of more than one parcel can be sold collectively or individually. [CCP §873.620]

### Notice of sale

The public or private sale of real estate must be conducted under the same rules for an execution sale on a money judgment. [CCP §873.640(a)]

For example, the *notice of sale* must be given to all parties named in the partition action at least 20 days before the sale date. [CCP §701.540(b)]

Additionally, the **notice of sale** must be published in a local newspaper of general circulation once a week for three weeks before the sale, similar to a trustee's sale under a power-of-sale provision. [CCP §701.540(g)]

### Bidding at the sale

At a public or private sale, the real estate is sold to the highest bidder. [CCP §§873.670, 873.680]

The only persons prohibited from bidding at the sale are:

- the referee;
- an attorney for the parties in the partition suit; and
- a guardian of a party to the suit, unless it is for the benefit of his ward. [CCP §873.690(a)]

These prohibitions are not in place at a trustee's sale where anyone can bid, including the trustee holding the private sale. In a partition action, if one of the co-owners wants to own the entire property, they can acquire it by making the highest bid.

#### Confirmation and distribution

After the highest bid is accepted, the sale is confirmed in a hearing which permits an overbid to be accepted at the hearing. [CCP §§873.720, 873.730]

The proceeds of the sale are distributed as follows:

- to the expenses of the sale;
- to the costs of the partition action;
- to the payment of the liens; and
- to the co-owners. [CCP §873.820]

Judgment is entered and is binding on all persons with claims known or unknown in the real estate. [CCP §874.210]

## Avoiding a partition action

What can be done by a co-owner to avoid the unnecessary costs of a partition action at the outset of a dispute between co-owners?

The keys to avoiding a partition action include:

- selecting the correct form of ownership; and
- including in the co-ownership agreement a provision for disposition of the property on termination of the co-ownership.

The best form of co-ownership of real estate is generally a limited liability company (LLC). In the LLC operating agreement, the co-owners agree in advance what will happen should one of the members want to withdraw or is expelled from the group.

A member himself has no interest in the LLC real estate, only a vote and entitlement to an accounting of the LLC's activities. [Corp C 17300]

On **dissolution of the LLC**, the member is only entitled to his percentage share in interest of the net *proceeds of a sale*, unless an agreement exists calling for a distribution of the real estate **in kind**. [Corp C §17250]

When a member's ownership interest in an LLC is assigned, whether voluntarily (to a buyer) or involuntarily (to a creditor), the assignee becomes a nonvoting member of the group. He has no voice in the LLC's business affairs, unless accepted as a member by a majority in interest of the existing members. [Corp C §§17301, 17303]

The operating agreement can also indicate events which terminate a member's interest, allowing others to buy out that member's interest (e.g., bankruptcy, failure to remove a charging order, death, assignment, etc.) at a prearranged price or valuation arrangement.

# Chapter 47 Quiet title to clear title

*This chapter explains the use of the quiet title action by owners of real estate to clear title of unenforceable claims, and distinguishes claims from liens.*

## The cloud of adverse claims removed

On receiving a preliminary title report after opening escrow, brokers are occasionally confronted with unexpected **title conditions** which will interfere with the closing of the sale if they are not removed from title to a property. Also, **off-record claims** occasionally arise before or after closing when the broker or buyer is advised of unrecorded documents which affect title, such as trust deeds, easements or license agreements.

These claims or conditions are collectively called *clouds on title*. Since **clouds on title** interfere with a transaction, brokers must consider effective ways to eliminate the clouds and close the transaction — the original goal of the buyer and the seller.

Presented here, in numerous scenarios, is a common involuntary resolution called a *quiet title action*. While the filing of a **quiet title action** necessarily involves the services of an attorney, the availability of quiet title relief to owners of property should first be raised by the broker in an effort to negotiate a resolution for owners confronted with a **cloud on title**.

## Quiet title: an overview

A **quiet title action** is a judicial procedure employed to determine claims to **nonpossessory rights** in disputes over title to real estate. [Calif. Code of Civil Procedure §760.020]

Title disputes over real estate interests which are resolved by a quiet title action include:

- a buyer against the holder of an easement which was unrecorded and unknown on the date of the buyer's acquisition of ownership;
- an owner or a buyer against the holder of an expired lien;
- one owner against another who claims to be the owner;
- a buyer in possession of property under a land sales contract, lease-option sale or a similar security device against a lienholder who is not the seller; or
- an adverse possessor against the owner of title.

Other title-clearing remedies, such as cancellation of instruments, removal of a cloud on title, declaratory relief and a partition action, are also awarded as part of a quiet title action. Nonjudicial voluntary resolutions (which are privately negotiated) include a release of the recorded instrument. [See **first tuesday** Form 409]

Conversely, an owner's **possessory remedies**, such as *ejectment* or *removal of improvements*, are separate causes of action which may be filed with a quiet title action when possession of the property is also in question. Ejectment and encroachment actions address possession, not title, and are unrelated to quiet title actions.

Besides possession, other disputed rights to real estate interests which are not resolved by a quiet title action include:

- a lienholder against the owner; or
- a buyer against the carryback seller to enforce a security device such as an unexecuted purchase agreement, a land sales contract or a lease-option sale.

## Record owner clears title

The record owner of a parcel of real estate eliminates unenforceable claims or other clouds on title, recorded or unrecorded, which are adverse to his ownership of the fee title by *quieting title* of the claim by a court order.

Unenforceable claims adverse to a fee owner's real estate interest which may be cleared from title by a quiet title action include:

- easements, right of ways and covenants, conditions and restrictions (CC&Rs);
- adverse possession;
- options; and
- trust deeds and other liens held by creditors.

An owner who is, or is a successor to, a *bona fide purchaser* (BFP) can eliminate claims against his interest in the property arising out of an unrecorded interest — such as a conveyance, lease, lien or use restriction — by commencing a quiet title action against the holder of the unrecorded interest.

A **bona fide purchaser** is a buyer of property for value and in good faith who acquired his ownership in a property while *unaware* of the existence of clouds on title which were:

- unrecorded;
- unobservable by a reasonable inspection of the property; and
- unknown to the buyer.

A buyer who purchases property from a BFP is called a *successor-in-interest*. The **successor-in-interest** is also considered a BFP, even though the successor may be fully informed about the cloud on title at the time of his acquisition.

Consider a real estate buyer whose seller does not inform him of an unrecorded easement to a utility company for the maintenance of underground utility lines on the property. The buried utility lines prevent the building of any structures within the easement.

The easement is not recorded and the lines are not apparent on a visual inspection of the property.

After acquiring the property, the buyer discovers the existence of the buried utility lines and demands their removal. The buyer seeks to quiet title against the utility company's claim to an easement on the property.

The utility company claims the buyer cannot quiet title since public interest requires the company to maintain the lines through the property.

Can the buyer demand the removal of the utility lines and clear the cloud of the easement from the title to his property?

Yes! The buyer is a BFP who was unaware of the unrecorded and unobservable easement when he purchased the property. As a BFP, the buyer has the right to remove the utility lines and quiet title of the easement.

However, if the utility company can show public interest necessitates the continued maintenance of the utility lines on the property, the buyer as a BFP is entitled to compensation in a separate action for his lost use of the land, called *inverse condemnation*. [**Pettis** v. **General Telephone Company of California** (1967) 66 C2d 503]

Further, had the buyer (or his broker) known of the unrecorded and unobservable utility easement, his title to the property would be subject to the easement. The buyer would not be entitled to the removal of the lines or compensation for **inverse condemnation** since his prior knowledge of their existence would not qualify him as a BFP.

### Buyer in escrow quiets title

A buyer, through his agent, locates a parcel of real estate he would like to acquire. During his agent's due diligence search into property and title conditions, a **cloud on title** is discovered. A prior owner of the property entered into a restriction agreement **prohibiting construction** on the property without a neighbor's prior approval.

The prior-approval agreement was not recorded or brought to the seller's attention until after the seller acquired title to the property.

The buyer and seller enter into a purchase agreement contingent on the neighbor's approval of the buyer's construction plans. However, the neighbor does not approve the buyer's construction plans.

The buyer then seeks to clear title of the cloud by a court ordered cancellation of the prior-approval agreement in a quiet title action. When the restriction is canceled and cannot be enforced, the buyer intends to close escrow on the property and proceed with construction.

The neighbor claims the buyer cannot cancel the agreement since the buyer is not the owner of record on title to the property.

However, the buyer has acquired an interest in the ownership of the property by having merely entered into a binding purchase agreement with the seller. Thus, the buyer can obtain a cancellation of the prior-approval agreement in a quiet title action since it is a cloud on title.

The buyer is an *equitable owner* of the property since he holds the contract right to purchase the property. As an **equitable owner** of the property, the buyer can quiet title against unenforceable claims which are adverse to his ownership interest in the property.

A pivotal factor in this case is the fact the seller was unaware of the unrecorded agreement entered into by the prior owner and the neighbor when he agreed to purchase the property.

Thus, the seller qualifies as a **bona fide purchaser (BFP)** since the agreement was neither recorded nor brought to his or his agent's attention before he agreed to buy. The seller's BFP status shields both the seller and the buyer, as the *successor-in-interest* to the seller, from the neighbor's enforcement of the restriction agreement. [**Reiner** v. **Danial** (1989) 211 CA3d 682]

## An all-inclusive remedy

A quiet title action may be joined with other causes of action related to the property. [CCP §760.030]

For example, a **quiet title** action to eliminate an adverse possessor's claim will be joined by an **ejectment** action to oust the adverse possessor from the property. [**Tobin** v. **Stevens** (1988) 204 CA3d 945]

Other claims used to clear title, which need not be stated as additional causes of action in a quiet title action, include:

- cancellation of instruments (removal of a cloud on title);
- declaratory relief (declaration of rights under an agreement or law); and
- partition (acknowledgement of co-ownership). [CCP §760.030]

In a quiet title action, a court may grant any equitable relief it deems necessary to quiet an owner's title. Thus, the lack of an additional **title-clearing** cause of action in the quiet title complaint does not deny the owner the relief necessary to resolve the title dispute. [CCP §760.040]

*Editor's note — Rarely are additional title-clearing causes of action excluded from a quiet title complaint. Typically, attorneys use a scattershot approach to drafting complaints, stating the*

### Non-BFP buyers clear title

Consider real estate which is encumbered with a recorded *security device*, a lien on the property entered into by the owner. The **security device** does not contain a **power-of-sale provision** authorizing a nonjudicial foreclosure on the property by trustee's sale. The security device may be a mortgage-in-fact grant deed given to a private lender, a two-party mortgage, a land sales contract, or a lease-option sales agreement entered into to acquire the property.

The owner defaults on the debt owed under the security device and the creditor (lender or seller) does not enforce collection.

More than four years after default on all scheduled and balloon payments, the owner conveys his interest in the property to a buyer without satisfying or clearing title of the creditor's lien. The buyer acquires ownership, legal or equitable, subject to the recorded security device.

As owner of the property, the buyer files a **quiet title action** seeking to eliminate the security device, claiming:

- the debt secured by the security device is uncollectible due to the four-year statute of limitations barring judicial enforcement of obligations arising from written debt instruments, sometimes called an *outlawed debt*; and

- the security device is an encumbrance which is now *extinguished* since no debt enforceable in a court of law remains to be secured by the property.

The creditor claims the buyer is barred from eliminating the security device as a lien on the property since the buyer purchased the property with full knowledge of the lien and thus is not a bona fide purchaser (BFP). In essence, the creditor claims the lien remains valid even though the debt is uncollectible in a court of law due to the passage of time.

Can the buyer quiet title in his name and eliminate the lien from title to the property?

Yes! Status as a BFP is not required to clear title of an **extinguishable lien** which has not been paid in full. The only out-dated lien which cannot be extinguished by a non-BFP buyer in a quiet title action is a **public improvement lien**. [**Mix** v. **Sodd** (1981) 126 CA3d 386]

A money obligation evidenced by a written agreement, a security device — usually a note and trust deed or installment sales contract — becomes **judicially unenforceable** after a period of time due to the *statute of limitations*.

Scheduled principal and interest payments in default for more than four years cannot be enforced against the owner through a court action, such as a judicial foreclosure, even when title is vested in the name of the creditor as security for payment of the debt, which occurs with a land sales contract, a lease-option sale or a mortgage-in-fact grant deed. [CCP §337]

Conversely, a trust deed **power-of-sale provision** allows nonjudicial private enforcement of a note by a trustee's sale for 10 years after the note's final due date. [Calif. Civil Code §882.020]

A **trust deed expires** and is automatically *extinguished* from the record:

- 10 years after the entire debt becomes due; or
- 60 years after the trust deed is recorded if the due date cannot be ascertained by the written records of the transaction. [CC §882.020]

*Editor's note — Under prior law, an owner could not quiet title of a lender's trust deed which was the owner's personal obligation. It was reasoned that to allow the owner to clear title of the lender's trust deed while the debt remained unpaid was tantamount to the court aiding him in avoiding his debt. [Mix, supra]*

*Now, all trust deeds automatically expire, clearing title without the need for a quiet title action after the 10-year or 60-year period. [CC §882.030]*

## Foreclose, do not quiet title, it's a loan

When a lender experiences a default on a loan secured by real estate, it should not attempt to *quiet title* to the secured real estate in its name. When a lender repossess real estate by a secured lender/creditor **quiet title** action as a method to foreclose, called *strict foreclosure*, the owner of the real estate is deprived of his *right to redemption* to pay off the debt and clear title of the lien.

A lender's quiet title action in lieu of foreclosure results in a *forfeiture* of the property to the lender since the property is not sold by an auction and followed by a **redemption** period for final payoff. Due to the **forfeiture** of the property, a valuation of each party's position on title and an accounting of the debt as of the **date of cancellation** is required since a quiet title action does not provide for the right of redemption.

Accordingly, a lender should always first foreclose by way of a judicial or nonjudicial (trustee's) foreclosure procedure. These foreclosure procedures provide a notice and opportunity for the borrower to redeem (keep) the property by paying off the debt — no forfeiture of the property on a default occurs as with a quiet title action.

*Editor's note — CalVet loans permit the forfeiture of a residence on a default — leaving no right of redemption — and are an exception to the mortgage law right-of-redemption policy.*

For example, when a buyer defaults on a **land sales contract**, the seller has three *remedies*:

- *rescind* the contract as though it never existed and *restore* the buyer to his pre-contractual position;
- *enforce* the seller's lien by a judicial foreclosure, or a nonjudicial foreclosure if the contract contains a power-of-sale provision; or
- terminate all rights under the contract by a quiet title action, sometimes referred to as a *strict foreclosure*.

When **rescinding** a land sales contract (or lease-option sale), the seller on recovering the property (voluntarily or by eviction) is required to **account for and restore** to the buyer all the money he received under the rescinded contract. Thus, everyone will be returned to their original position as though the transaction had never occurred, called *restoration*.

**Offsets** are given to the seller for the rental value of the property during the entire period of the buyer's occupancy. In turn, the buyer receives credit for all payments made toward the principal and interest under the contract.

Conversely, when the seller sues to **quiet title**, the seller is not restoring the parties to their pre-contractual positions. By quieting title, the seller is affirming and enforcing the contract — from *inception to default* — since he acts to remedy the default by terminating the contract and *forfeiting the buyer's equity* in the property.

When the seller carries back an installment sales contract and **quiets title** to terminate all the buyer's contract rights to acquire the property due to the breach, the buyer is entitled to *restitution*, not just **restoration**, as though the deed had never occurred.

## Quiet title for the wrong reason

**Restitution** is an accounting between the buyer and seller which results in a refund to the buyer in exchange for the return of the property to the seller. However, if the property value has dropped and no credits are owed to the buyer to offset the drop in the value, no money judgment for the deficiency is available to the seller. [CCP §580b]

For example, a buyer purchases real estate under a land sales contract for the price of $400,000. A down payment is made. To pay the balance of the purchase price, the buyer agrees to takeover payments on an existing trust deed note, paying the installment directly to the lender or indirectly through the seller. Installments are also due the seller for the balance of his equity in the property.

The buyer takes possession of the property and makes principal and interest installments to the seller, as well as payments on the trust deed note.

Later, the buyer defaults on his payments, resulting in a *material breach* of the land sales contract. The seller terminates the contract by a notice of cancellation. The fair market value (FMV) of the property on the date of the breach is $300,000.

The buyer refuses to surrender possession of the property and continues to make principal and interest payments on the underlying trust deed.

The seller sues to quiet title of the buyer's land sales contract. A receiver is appointed to operate and maintain the property until the trial.

At trial, the seller regains possession of the property and the court calls for an accounting.

### The seller's accounting for his losses

The seller's **losses** include:

- the *benefit of his bargain* under the land sales contract;
- *out-of-pocket expenses* caused by the breach; and
- other expenditures which naturally flow from the breach, called *consequential damages*.

During the buyer's equitable ownership of the property prior to his breach, the seller's **benefit of the bargain** under the land sales contract is calculated as the purchase price, less the current value of the property as of the date of breach (if it is lower).

In this example, the seller's lost benefit of the bargain is $100,000 — the sales price of $400,000 less the property's lower current value of $300,000.

However, the seller is also entitled to **out-of-pocket expenses** for the buyer's wrongful retention of the property after the date of the breach. After the date of the breach, the buyer's continued possession of the property is treated as though he were renting it, not buying it and owing interest, since his purchase contract and his ownership has been terminated by the notice of cancellation.

Thus, the seller is owed the fair rental value of the property from the date of the cancellation to the eviction of the buyer. Rent compensates the seller for the seller's loss of use of the property during the buyer's wrongful (holdover) possession of the property. [CC §3307]

The repossessing seller also receives credit for any expenses that are the **natural consequence** of the buyer's breach, including:

- payment of delinquent real estate taxes prior to termination of the contract;
- payment of any assessment bonds or association fees until termination of the contract;
- payment of penalties or fees for reinstating the trust deed;
- receivership costs;
- resale costs if the property is resold; and
- the cost to repair/replace any damage to the physical property over normal wear and tear.

### The buyer's accounting for his forfeiture

On the other hand, the buyer having forfeited all rights to the property due to the breach gets credit for:

- the down payment;
- installments of principal paid to the seller on the land sales contract, excluding interest;

- principal payments on the trust deed note paid by the buyer prior to termination of the land sales contract, excluding interest;
- principal and interest payments paid by the buyer after termination of the land sales contract (during the buyer's wrongful holdover possession of the property); and
- any expenses paid by the buyer after the breach which the seller should have paid, such as care, maintenance and further improvements to the property since the buyer's ownership interest has been terminated.

The buyer's payments of interest to the seller during his equitable ownership are not an offset and are retained by the seller since the interest payments are the seller's earnings for the buyer's use of the principal remaining unpaid on the purchase price. The interest paid to the holder of the trust deed note **prior to termination** of the land sales contract is also not an offset since interest is part of the buyer's burden of ownership under the land sales contract.

Owners, equitable or legal, **do not owe rent** for their possession since they own the right to occupy (or to let) the property.

However, interest paid on the trust deed by the buyer **after termination** of the land sales contract is a credit due to the buyer. On the seller's termination of the land sales contract and commencement of the buyer's wrongful possession, the buyer only owes rent to the seller (which replaces any obligation to pay interest on the unpaid purchase price under the terminated land sales contract).

After the accounting is complete, if the amount the buyer is entitled to is greater than the credit the seller received for his losses, the buyer is entitled to a refund of the difference, called *restitution*. **Restitution** is the excess of the buyer's payments over the money losses incurred by the seller due to the buyer's breach of the contract and holdover possession of the property. The buyer is entitled to a money judgment for the amount of restitution. [**Kudokas** v. **Balkus** (1972) 26 CA3d 744]

Conversely, the seller is unable to obtain a money judgment against the buyer due to anti-deficiency laws controlling recovery of purchase-money debts.

The negotiation and execution of a deed-in-lieu of foreclosure on the land sales contract or lease-option sale would avoid the litigation and accomplish a mutually acceptable result — recovery of the property and a settlement. [See **first tuesday** Form 406]

## Equitable ownership versus the trust

An *equitable owner* of real estate is a person who purchased the property and has not yet received a grant deed conveying **legal ownership** into his name. A buyer who is an **equitable owner** may quiet title of adverse claims which threaten his ownership interest in the property.

## Equitable owners include:

- beneficiaries of an irrevocable trust, but not of a revocable inter vivos (living) trust;
- buyers in possession of property under a contract for deed, land sales contract or lease-option sale;
- buyers in escrow under purchase agreements; and
- owners in possession of property who have been defrauded of their legal title.

For example, four individuals buy a parcel of real estate as co-owners. An **irrevocable trust agreement** is entered into by the co-owners as beneficiaries.

One of the beneficiaries holds legal title to the property in his individual name, as trustee under the trust agreement. As trustee, he annually pays the real estate taxes from funds contributed by all beneficiaries.

The beneficiaries further agree that each is to possess a separate portion of the real estate which they are to exclusively occupy, called *divided interests*.

One of the beneficiaries conveys his divided interest in the real estate to his daughter by an assignment of his beneficial rights under the trust. The daughter takes and remains in possession of the real estate for more than five years.

The daughter then seeks to quiet title in her name to the portion of the property she exclusively possesses as against the other beneficiaries and the trustee, claiming she acquired title to her portion through *adverse possession*.

Can the daughter quiet title against the other beneficiaries and the trustee through **adverse possession**?

Yes and no! Yes, the daughter can quiet title against any claims the other beneficiaries may have in the portion of the real estate she exclusively occupies. However, she cannot quiet title in her name as against the trustee since he holds legal title and pays the taxes. Thus, title remains in the name of the trustee.

Unlike a limited partnership or limited liability company (LLC) vesting which creates a separate entity to own the property, a trustee merely holds title for the benefit of all occupants who are beneficiaries of the trust agreement.

As a successor-in-interest to one of the beneficiaries, the daughter is a **beneficiary of the trust**. Thus, she holds an *equitable ownership* interest to the portion of the real estate exclusively occupied by her and her predecessor. No entity intervenes as the owner of her portion by holding title, such as an LLC.

To take title from the trustee to the portion exclusively possessed by the beneficiary in this example, the daughter as a beneficiary is limited to **enforcement of the trust agreement**, a contract law remedy, not a real estate law remedy (such as a quiet title action). [**Tuffree** v. **Polhemus** (1895) 108 C 670]

## Equitable owners by purchase agreement

Similarly, a buyer under a **purchase agreement** which is yet to be performed by closing escrow, or an optionee holding a purchase option, is an **equitable owner**. However, these buyers under contract may not use a quiet title action to resolve their claims to fee title against the owner of record who has yet to fully perform under a purchase agreement or option to sell the property.

The buyer's or optionee's remedy against the owner is *specific performance* of the purchase agreement or the option. Yet-to-be-performed real estate agreements which are enforced by specific performance include purchase agreements and escrow instructions, trust deed notes, leases and options.

*Editor's note — Quieting title and partitioning real estate against the other co-owners gives rise to* ***subdivision issues.***

*A partnership agreement giving a partner exclusive occupancy to a portion of the real estate, unless recorded in a grant deed or lease, does not violate subdivision law as long as the partnership pays all expenses on the property from capital contributions made by the partners, not from rent paid by the partners. [**Bakanauskas** v. **Urdan** (1988) 206 CA3d 621]*

*Further, the purchase of rental or investment property by five or more co-owners vested as tenants in common creates a subdivision requiring clearance from the Department of Real Estate (DRE) except in cases where the undivided interests are:*

- *held by people related by blood or marriage;*
- *created as a result of a foreclosure sale;*
- *created by a valid court order;*
- *offered and sold by permission of the Commissioner of Corporations according to the Corporate Securities Law of 1968; or*
- *in real estate offered for sale as an authorized time share project. [Calif. Business and Professions Code §11000.1]*

*Additionally, a subdivision is not created when the undivided interests are purchased by less than 10 people who each give a signed statement to the Real Estate Commissioner acknowledging that they are:*

- *fully informed about the ownership risks;*
- *purchasing the interest for themselves without present intention to resell the interest; and*
- *waiving any protections afforded under a subdivision. [Bus & P C §11000.1(b)(2)]*

## Unrecorded owner in possession

Consider a buyer of real estate under a land sales contract. The seller **retains legal title** to the property as security for the buyer's payment of the remaining unpaid balance of the purchase price.

The buyer then enters into a construction and co-ownership agreement with a contractor to improve the property. The contractor is to build four houses on the property and pay the balance remaining due on the purchase price under the land sales contract.

In exchange, the contractor is to receive a 75% ownership interest in the property, as a co-owner with the buyer. The buyer is given the rights to exclusively occupy one of the units.

As agreed, the contractor pays off the balance due on the land sales contract to the seller. However, the seller conveys title to the contractor, not the buyer named in the land sales contract. The buyer occupies one of the residences on the property.

The contractor then encumbers the property with a trust deed loan without the consent of the buyer whose 25% co-ownership interest is not recorded.

Neither the lender holding the trust deed nor the title company insuring the trust deed inspect the property for occupants, much less inquire into interest held in the property by those in possession. Thus, the lender is actually unaware the co-owner of a 25% undivided interest exists or occupies the property.

Later, the buyer learns of the lender's trust deed encumbrance and seeks to quiet title against the lender's lien on the buyer's unrecorded 25% ownership interest in the entire property.

The lender claims the buyer cannot quiet title of its security interest since the contractor holds title and thus the buyer is not the owner of record.

However, when originating a loan, the lender has a duty to inspect the property, as well as the record title, for any off-record claims to title before making a loan secured by the real estate. The buyer's **actual possession** of the property places the lender on *constructive notice* of the buyer's ownership interest.

Thus, the contractor's trust deed lien never attached to the buyer's unrecorded ownership interest and the quiet title action *extinguishes* the trust deed lien from the buyer's 25% undivided ownership interest in the property. [**Dement** v. **Pierce** (1932) 122 CA 254]

### Protecting non-fee title interests

The holder of an interest in real estate other than the fee title, such as an easement, right of way, lien, lease, option or by adverse possession, may also use a quiet title action to **eliminate claims** which challenge the interest he holds in the real estate.

Non-fee interests, such as possession held by tenants under the leasehold interest they own, may be protected by the use of a quiet title action — although the tenant's interest is not based on ownership of the fee interest in the real estate and title cannot be quieted in the name of the tenant. [Tuffree, *supra*]

Only an occupant who can establish a **claim of title** to property, such as by adverse possession, equitable ownership or strict foreclosure and forfeiture by a lender, can *quiet title* to the property in his name and become the owner of record. [See Chapter 30]

For example, a husband and wife dissolve their marriage. The wife is awarded the community residence and the husband is ordered to transfer possession of the residence to the wife.

Accordingly, the wife asks the husband to vacate the property. However, the husband refuses to vacate and remains in possession of the property for more than five years after the ownership and possession of the property are awarded to the wife. During the entire five-year period, the husband pays the taxes and other costs for maintaining and carrying the property and the wife takes no legal action to evict him.

Claiming title by **adverse possession**, the husband files a quiet title action to eliminate the wife's recorded ownership interest in the property. The wife claims the husband cannot quiet title since his possession is in violation of the court order awarding her the property.

Can the husband quiet title even though his possession is wrongful?

## Lis pendens

When an action to quiet title is brought, a lis pendens describing the real estate must be recorded with the county recorder's office where the property is located. The recorded lis pendens puts potential lenders and buyers of the property on notice of the pending quiet title action. [CCP §§405.24; 761.010]

Title to the property may still be conveyed subject to the recorded lis pendens and the risks of the litigation's outcome.

If a buyer purchases the property from a seller whose ownership interest is later eliminated by a quiet title action when a lis pendens was of record prior to closing, the seller's conveyance to the buyer will be voided as part of the quiet title action. [CCP §405.24; see Chapter 42]

Yes! The husband has acquired title by adverse possession. The husband's possession is hostile since he did not vacate when asked, and he paid the taxes for a period of five years or more

An individual claiming ownership by adverse possession must have hostile possession of a property without the legal owner's stated or implied permission. He must also pay taxes and all encumbrances on the property and wait out the required five-year period in possession of the property (without being evicted) to obtain legal title. [**Buic** v. **Buic** (1992) 5 CA4th 1600]

### Squatter's rights and nonresident owner

Consider an owner of record to real estate who has not occupied his property for over five years.

A **trespasser** has possession of the property and claims to be the true owner, but has not paid **property taxes**. The owner seeks to *quiet title* of the trespasser's claim to ownership and remove him from the property by ejectment.

The trespasser claims the owner is barred from recovering the property and **ejecting** him since the owner has not himself been in **physical possession** of the property within the last five years.

Can the owner quiet title of the trespasser's claim and remove him from possession of the property?

Yes! The trespasser is unable to establish a right to title by adverse possession since he has not paid the taxes on the property. Also, the owner of record at all times has the right to **immediate possession** of the property by **ejectment** of anyone not legally in possession or cannot prove an adverse possession claim. Thus, the owner is able to quiet title against the trespasser's claims. [**Tobin** v. **Stevens** (1988) 204 CA3d 945]

### Five years to perfect title

A creditor records an *abstract of judgment*. The **abstract of judgment** attaches as a lien on title to a parcel of real estate which is vested of record in the name of the judgment debtor.

The judgment debtor later sells and conveys the property to a buyer.

The creditor obtains a **writ of execution** to foreclose the judgment lien and is the highest bidder at the sheriff's sale. The creditor receives a **certificate of sale** entitling it to a sheriff's deed and immediate possession of the property. However, the interest acquired in the property has no present value to the creditor due to the amount of the encumbrances with priority.

The buyer remains in possession and pays all taxes and encumbrances on the property.

The creditor waits more than five years after the sheriff's sale, when the value of the property has increased, to obtain and record the sheriff's deed. The creditor files a quiet title action against the buyer, claiming the sheriff's deed gives the creditor legal title and the right to possession.

The buyer claims the creditor has no right to quiet title to the property in the creditor's name since the creditor did not **possess or hold title** to the property within the five year period after the date of the sheriff's sale.

Is the creditor entitled to the property?

No! The creditor is barred from asserting a claim to the property. The creditor's right to record the sheriff's deed and to take possession of the property and eject the occupant first arose on the date it purchased

the property at the sheriff's sale. The five-year *statute of limitations* begins to run on the creditor's right to recover the property from the date it is first possible for the creditor to bring a suit to eject the buyer, which is the date of the sheriff's sale.

By the five-year delay in recording the sheriff's deed, the creditor lost its right to recover the property from the buyer. An injunction against the creditor's claim to ownership clears the buyer's title of the creditor's unenforceable sheriff's deed. [**Lawrence** v. **Maloof** (1967) 256 CA2d 600]

Had the creditor recorded the sheriff's deed and filed his quiet title action within five years after the sheriff's sale, the creditor would have been entitled to possession. The buyer would then be unable to prove his claim to title as an *adverse possessor* by his payment of taxes and possession for five years.

# Chapter 48 — Specific performance, loan commitments and attorney fees

*This chapter covers the liability of a breaching seller on the buyer's enforcement of a purchase agreement for any increase in the interest rate on a buyer's purchase-assist loan and the buyer's attorney fees.*

## Future shock in a recovery

A buyer and his agent have been working for over a year to locate and buy a home at the lowest possible price. They have observed sales volume, loan originations, property prices and construction starts decline without an increase for the past three or four years.

However, interest rates are now falling from their highs during the past two or three years, as are foreclosure rates and the level of unsold inventory of listed and newly constructed homes.

The buyer senses the lull forming the bottom of this real estate recession is about to end. A comparable market analysis for properties the buyer is interested in indicates prices are no longer dropping, but are firming. Construction starts are even beginning to turn up and lenders are reported as being more lenient on credit scoring, qualifying buyers who a year ago could not qualify for financing.

Realizing that the dynamics of the local real estate market are changing and the prices will soon start to rise due to a reduction in available properties from which to select a home, the buyer decides now is the best time to make an offer. The buyer and his agent review the properties they have determined would be a suitable residence for the buyer. Offers will be made at the best (lowest) price possible for a purchase at the end of this recessionary phase in the real estate sales cycle.

Soon after making a few offers, the buyer enters into a purchase agreement with a seller to acquire a property. The purchase agreement contains a provision which conditions the close of escrow on the buyer arranging and recording a purchase-assist loan to fund his acquisition of the property.

Prior to the date for the close of escrow, the seller discovers real estate values have surged upward, driving up the value of his property beyond the price the buyer has agreed to pay. Seeing he can get a much greater price from a flood of prospective buyers in the suddenly competitive market, the **seller cancels** his sale escrow instructions days before the scheduled closing.

The buyer makes a demand on the seller to close escrow as agreed in the purchase agreement and escrow instructions, which the seller rejects. The buyer files a *specific performance* action to enforce the purchase agreement and require the seller to close escrow. At trial, the buyer prevails and the seller is **ordered to close escrow**.

## An offset for increased interest

To continue with the prior example, **interest rates** offered by lenders on the purchase-assist loan called for in the purchase agreement have increased during the **time lapse** between:

- the date scheduled for performance (close of escrow) in the purchase agreement breached by the seller; and
- the date of the specific performance judgment ordering the seller to convey title and close escrow.

Can the buyer recover as part of his **specific performance judgment** the amount of the increased interest the buyer will pay on the purchase-assist loan he must now arrange to pay the purchase price and close escrow?

Yes, the cost of increased interest is recovered as a **direct offset** on the purchase price. When a seller breaches, it is foreseeable interest rates on purchase-assist financing called for as a condition for payment of the purchase price will rise by the time the seller is ordered to convey the property to the buyer.

Thus, it would be unreasonable for the buyer to pay both the original purchase price and the **increase in the interest rate** on a fixed rate loan when the increase is brought on by the seller's delay in conveying title until the time of a court ordered specific performance. [**Hutton** v. **Gliksberg** (1982) 128 CA3d 240]

If the interest differential in the increased rate on the purchase-assist financing available at the time the purchase agreement is enforced by specific performance was not borne by the breaching seller, the buyer would be deprived of the **economic benefit** of the lower interest he arranged at the time escrow was originally scheduled to close.

Conversely, if interest rates were to **drop** by the time the buyer is awarded ownership of the property in a specific performance action, none of the buyer's economic windfall due to the financial benefits of lower interest rates becomes a credit to the seller since:

- the seller cannot benefit from his misconduct which prevented the timely closing [Calif. Civil Code §3517]; and
- the buyer has incurred no loss.

## The price paid and attorney fees due

Consider a buyer who enters into a purchase agreement with a seller to buy real estate. Prior to closing, the seller cancels the transaction. The buyer files a **specific performance** action to enforce the purchase agreement and acquire the property. The buyer prevails and the seller is ordered to deed the property to the buyer.

Having prevailed at trial on his specific performance action, the buyer now takes steps to enforce the **attorney fees provision** in the purchase agreement. The buyer seeks to directly offset the amount due on the price he will pay for the property by deducting the amount of the attorney fees he is awarded.

Can the buyer deduct the attorney fees award directly from the purchase price of the property?

No! An attorney fee award must be collected from the seller after recording the **abstract of judgment** for the attorney fees. The judgment for attorney fees is separate from the terms for payment of the purchase price.

If the amount of the attorney fees were to reduce the purchase price of the property as an offset to the amount due the seller, that enforcement of a money judgment for attorney fees would function retroactively as a *super lien* on the seller's property. **As an offset** to the price to be paid, an award of a money

judgment for attorney fees would have *priority over any liens* recorded on the property prior to receiving the judgment for attorney fees, as well as priority over the amount of the seller's homestead exemption.

Additionally, the amount due the seller for his price as called for in the terms for payment of the purchase agreement would be improperly altered by an offset. The buyer must pay the total amount due the seller on the purchase price and then, on close of escrow, collect the money due to him for his attorney fees by recording and executing on an abstract of the money judgment based on the priority status of the abstract to other liens on title. [**Behniwal** v. **Mix** (2007) 147 CA4th 621]

Unlike the *interest rate differential* on the purchase-assist loan which was part of the **terms for payment** of the purchase price in our prior example, the recovery of attorney fees for enforcing a purchase agreement is separate from the price paid for the property. A judgment for attorney fees cannot take priority over liens and homestead claims arising before entry of the money judgment for those attorney fees. Hence, the issue of priority of claims on the price paid to the seller.

## Calculating interest losses

Two accounting formulas exist for calculating future money losses a buyer will incur due to the interest differential in the increase in interest rates on his purchase-assist **fixed-rate loan**:

- the *loan-term formula*, based on the dollar amount of increased interest the buyer will pay over the full term of the loan, discounted to its present value based on current capitalization rates [Hutton, *supra*]; or
- the *ownership-term formula*, based on the dollar amount of increased interest the buyer will pay over the buyer's anticipated holding period before a refinance or resale, discounted to its present value. [**Stratton** v. **Tejani** (1982) 139 CA3d 204]

A buyer financing his purchase with a variable or adjustable rate loan (ARM) is not likely to incur unexpected interest rate loss when interest rates increase. The buyer's bargain for ARM financing is to pay the prevailing short-term rate, adjusted monthly, quarterly or semi-annual, for the duration of the loan.

## Loan-term formula for long-term buyer

For example, monthly payments on a loan origination at a fixed interest rate of 14% with a 30-year maturity on a principal of $400,000 would be $4,739.49. The same loan amount and amortization period at 9.25% carries a monthly payment of $3,290.70.

The difference in the monthly payment resulting from the increase in the interest rate is $1,448.79 per month. Over 30 years, this difference will cost an additional $521,564.40 in actual out-of-pocket dollars.

Discounting the dollar amount of the increase in payments at the then current rate of 14% over a 30-year period results in a *present cash value* of $122,274. Thus, under these loan conditions, awarding the buyer $122,274 now indemnifies the buyer for the increase in monthly payments he will later pay due to the seller's breach.

The **loan-term formula** indemnifies the buyer for future losses over the entire life of the loan. The likelihood the buyer will refinance or resell before the loan term expires calls into consideration the **ownership-term formula**.

### Ownership-term formula

The alternative ownership-term formula of accounting requires a determination of how long the buyer intends to retain ownership of the property subject to the high interest rate loan. Does the buyer intend to retain the property or the fixed-rate financing for a short-, medium-or long-term period?

The ownership period during which the seller will pay an increased interest rate under the ownership-term formula runs until the date it is anticipated the buyer will **resell or refinance** the property. Thus, the buyer is not awarded a **windfall** if the interest rate in the mortgage market drops and the buyer refinances or he resells the property, putting an end to his payment of the higher interest rate. In this instance, the ownership-term formula is more equitable and economically prudent than the loan-term formula.

To establish the buyer's probable **ownership period** before a refinance or resale would likely occur, consider:

- whether the property is the buyer's principal residence, business or investment property;
- the cyclical nature of the rise and fall of interest rates on ten-year treasury notes;
- the buyer's prior ownership history;
- the ratio of the monthly payments to the buyer's income; and
- the buyer's employment history.

A persistent high level of interest on fixed-rate mortgages eventually translates economically into lower property values. This reciprocal movement between rates and values is due to the sympathetic and concurrent rise in capitalization rates used by real estate investors to set values when interest rates rise. Thus, a court award of the present worth of the increase in interest payments during a buyer's ownership functions in all respects as a **discount** on the price the buyer and seller agreed to in the purchase agreement.

These same financial and economic arguments apply to lower pricing when a buyer makes a decision about financing a property acquisition during a period of high interest rates on long-term mortgage financing.

# Chapter 49 Declaratory relief prevents more costly litigation

*This chapter explores the use of a declaratory relief action to resolve a real estate dispute before performing the contract or employing other remedies which would be expensive to reverse.*

### Disputes resolved before closing

A buyer is interested in purchasing an unimproved parcel of real estate on which to build a residence as allowed by zoning.

Before the buyer and seller enter into a purchase agreement, a neighbor informs the seller's listing agent a written agreement between the prior owners of the neighbor's property and the seller's property prohibits the construction of any improvements on the seller's property.

However, the agreement is not recorded and the seller was previously unaware of the existence of the use restriction. The agent believes the agreement is not binding since it was not recorded and the seller acquired the property without knowledge of the use restriction.

Before closing, the buyer is advised of the agreement and requests the neighbor's permission to build improvements on the property.

The neighbor refuses to grant the buyer permission, claiming the agreement is a covenant running with the land which is binding on all subsequent owners, including the buyer. No one wants escrow to close due to the uncertainty that the property can be used as expected.

To resolve the dispute over the use restriction agreement, the buyer and seller join together and file an action against the neighbor for *declaratory relief*.

The buyer and seller do not seek to recover any money losses or property from the neighbor. They only seek a **declaration of their rights and obligations** under the use restriction agreement entered into between the prior owners of the contiguous properties. Also, the buyer and seller agree with the agent to an extension of their escrow period with closing contingent on a favorable result in the **declaratory relief** action they filed.

The neighbor claims the buyer is barred from pursuing declaratory relief since he is merely a prospective buyer with no ownership interest in the property.

However, an **actual controversy** exists since the use restriction could force the buyer into further litigation after acquiring the property. If the buyer were to purchase the real estate and begin constructing improvements as allowed by zoning, but in violation of the unrecorded agreement, he would expose himself to an expensive and time-consuming lawsuit with the neighbor and possibly need to remove the improvements.

Thus, the buyer is entitled to a declaration of his rights to resolve the uncertainty before buying the property and constructing improvements since the buyer holds an *equitable ownership interest* in the property under his purchase agreement with the seller.

Likewise, the seller is entitled to a declaratory judgment since he will also be directly affected by the outcome — the closing of the sale is contingent on the buyer's ability to make improvements. [**Reiner** v. **Danial** (1989) 211 CA3d 682]

With a declaratory judgment, the agent is able to keep alive an otherwise dead transaction.

## Preventative justice for a certain future

When one person sues another, he is typically seeking to recover something tangible — money, property or a right such as an easement.

However, controversies over the *nature of rights* or the *interpretation of agreements* frequently arise long before they produce any claims for the recovery of money or property. A prudent individual often wants to know what his rights and duties are before he undertakes irreversible actions which may result in costly litigation.

The declaratory relief statutes allow a person to obtain a **declaration of his rights** and obligations before an actual claim arises for the recovery of money or property, or a breach of an obligation. [Calif. Code of Civil Procedure §1060]

### Resolve your disputes, then act

The real estate activities which give rise to a declaratory relief action include:

- trust deed **foreclosures** in which borrowers may have claims which cast doubt on the lender's or carryback seller's ability to foreclose, such as claims of misrepresentation or demands for offsets;
- **rental** or **lease** agreements involving such issues as the renewability of a lease or the landlord's demands for rent;
- **lease-option sales** with their frequently misunderstood legal status as security devices which raise questions as to the ownership rights of the seller/landlord and buyer/tenant;
- **right of first refusal** agreements which raise questions about whether a particular activity or event has triggered the first refusal right to acquire the property;
- **cancellation** of purchase agreements or **rescission** of closed transactions;
- claims of **usury** on private lender loans;
- **priority** of liens and **validity** of subordination agreements;
- **prepayment penalty** enforcement [**Sacramento Savings and Loan Association** v. **Superior Court County of Sacramento** (1982) 137 CA3d 142];
- enforceability of **trust deed provisions** [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943]; and
- **due dates** for the final payoff of a loan or performance dates for any other obligation.

To expedite the resolution of controversies which could result in a future loss and litigation, actions for declaratory relief are given **priority** over the court scheduling of other kinds of actions. [CCP §1062.3]

When a claim for declaratory relief arises due to a performance which is already in process, such as construction or foreclosure, the contested activity is typically postponed, or *stayed* by the court, until the declaratory relief action is resolved.

The differing parties in a declaratory relief action often enter into a *Reservation of Rights Agreement* allowing them to preserve their respective claims so they can later pursue them after a court declares their rights. The purpose of the **stay** with **reservation of rights** is to maintain the status quo, such as the acceptance of loan payments on a loan in dispute, until the uncertainty is resolved by a declaratory judgment. [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943]

Thus, declaratory relief functions as a kind of **preventive justice**, settling controversies before they result in litigation to recover money, convey property, rescind a transaction, reconvey property lost to foreclosure or reoccupy a premise after an eviction.

## No breach required for clarification

Declaratory relief is based on an individual's *right to know* where he stands in relation to the adverse claims made by another person which might affect his position. If an individual is contemplating activity which he or others feel may be prohibited by law or contract, he is entitled to know whether the activity is permitted before undertaking it.

For instance, consider an owner who believes his property is no longer subject to **deed restrictions** against construction which were recorded many years earlier.

To know for certain whether the deed restrictions apply to him, the owner can either:

- **undertake construction activities** in violation of the restrictions (but not zoning ordinances) and run the risk of a potentially expensive lawsuit; or
- **obtain a declaration** from the court stating whether the restrictions are still binding before he proceeds with construction.

The owner is not required to breach his obligations before he can seek a judicial determination of his rights. Thus, the owner is entitled to a declaratory judgment clarifying his rights which will either allow him to proceed safely with his desired construction activities, or notify him the restrictions are still in effect. [**Ross** v. **Harootunian** (1967) 257 CA2d 292]

## Predetermining legal results

Proceeding with activities under dubious authority without first obtaining a declaratory judgment can produce disastrous financial results.

For example, a buyer of real estate seeks to **rescind** his recently closed acquisition of property after grading it.

Without first seeking a court declaration of his rights, the buyer deeds the property back to the seller, called *rescission*. He then makes a demand on the seller to recover the purchase price and the costs of carrying the property during his ownership, called *restoration*.

The seller accepts the deed to the property but refuses to return any money to the buyer, claiming he physically damaged the property when he graded it in preparation for construction.

Ultimately, the buyer is unable to recover any money through **restoration** since he inflicted damage on the property by grading it. Thus, the buyer now has neither the property nor the money. [**Grill** v. **Hunt** (1992) 6 CA4th 73]

A declaratory judgment would have clarified whether the buyer was entitled to recover the purchase price by rescinding the transaction, and if so, the basis for valuation of the property on its return. Thus, the buyer would be able to decide whether to proceed with the rescission, which would have "restored" the property to the seller and the money to the buyer, or keep the property.

### Anticipating a breach before closing?

Declaratory relief can also take the place of a buyer's or seller's claim that the conduct of the other party is an *anticipatory breach* of their purchase agreement, lease agreement or note and trust deed.

An **anticipatory breach** occurs when a buyer or seller in some way acts to repudiate the purchase agreement before the time for closing arrives — manifesting through words or conduct his intent not to further perform on his agreements. [Calif. Commercial Code §2610]

However, proving an anticipatory breach can be difficult since it is a claim for nonperformance before the time of performance by closing escrow has even arrived.

Thus, rather than attempting to prove a buyer or seller does not intend to perform on his agreement or close a transaction, a better remedy might be a declaratory relief action to determine if the other party's activities constitute a breach of the agreement. With a declaration of his rights in hand, the injured party can then pursue a specific performance action or recover his money losses for a breach should escrow not close.

### Interpreting government agency rights

Declaratory relief can be sought to interpret nearly any kind of right or obligation.

For instance, a property owner may seek a declaratory judgment testing the validity of a city **zoning ordinance**. [**Viso** v. **State** (1979) 92 CA3d 15]

Additionally, an owner may seek declaratory relief before entering into a transaction which may result in a **tax liability** to determine what his liability would be if he undertook the activity. Since tax liability does not accrue before the transaction is completed, a declaratory judgment does not illegally prevent the collection of a tax. [**Honeywell, Inc.** v. **State Board of Equalization** (1975) 48 CA3d 907]

However, owners involved in tax disputes with state government agencies have no recourse to declaratory relief once the taxes are levied. Courts may not prevent the collection of taxes which are now due to state agencies. The owner's remedy is to pay the taxes and pursue an action for a **refund of excess taxes paid**. [Calif. Revenue and Taxation Code §§6931, 6932]

### Interference with future events

Consider a tenant operating a barber shop who subleases a portion of the premises to a subtenant who sets up a smoke shop. The sublease grants the subtenant an **option to renew** the sublease contingent on the tenant renewing his lease.

The tenant arranges for his son to lease the property from the landlord at the end of the current lease term rather than renew or extend it himself. The tenant then informs the subtenant he will not be renewing the lease, and thus the sublease will be terminated at the end of the current term.

The subtenant claims the leasing of the property by the tenant's son is merely a ploy to terminate the sublease.

No cause of action yet exists for money losses or breach of the option to renew since the sublease is still in effect and no one is seeking to evict the subtenant.

However, due to the words and conduct of the tenant, a **controversy exists** as to whether the subtenant is entitled to renew his sublease. The subtenant seeks a declaration of his **right to renew his sublease**.

A declaratory judgment is handed down by the court stating the leasing of the property by a member of the tenant's family constitutes a renewal of the lease. With his rights established by a court order, the subtenant will be able to exercise his option to renew the sublease when the time to exercise the option arrives. [**Jones** v. **Feichtmeir** (1949) 95 CA2d 341]

### Useful purpose of ending litigation

The requirements for obtaining a declaratory judgment are:

- an **actual controversy** exists as to a person's rights or duties; and
- the controversy will likely result in **future litigation** if not resolved.

Thus, a declaratory judgment is only granted if the judgment will serve a **useful purpose**. The court may deny declaratory relief if no declaration is necessary or proper. [CCP §1061]

For example, a buyer and seller sign a purchase agreement. Later, a third party records an option to purchase the property.

The seller informs the buyer he will be unable to deliver title to the property due to the option. The buyer's deposit is refunded and the property is sold to the optionee.

## Cumulative remedy

Declaratory relief is a **cumulative remedy**. A person who is granted declaratory relief in a dispute may recover for other sorts of relief available to him arising out of the same dispute. [CCP §1062]

For instance, a lease agreement allows the landlord to terminate the lease if the tenant assigns the lease without the prior landlord's consent. However, the tenant assigns an interest in the lease to a partner without obtaining consent.

The landlord claims the unauthorized assignment allows him to terminate the lease. The tenant claims the landlord cannot terminate the lease based on the assignment since he only assigned a partial interest in the lease, and still retains an interest himself.

Rather than file an unlawful detainer (UD) action, the landlord obtains a declaratory judgment ruling that he can terminate the lease. Thus, if the dispute with the tenant is resolved in the land-

The buyer now claims the seller breached the purchase agreement and seeks a declaration of his rights. However, the buyer does not seek any other form of relief, such as the recovery of money losses or specific performance of the purchase agreement.

Thus, the buyer's claim for declaratory relief amounts to asking the court to declare the seller breached the purchase agreement when he conveyed the property to the optionee.

This is a **useless declaration** since it has no effect on the future rights or claims between the parties. The relationship between the buyer and seller was already terminated and the seller no longer owns the property.

Thus, any claims of the buyer against the seller can only be for money losses incurred by the termination of the agreement, for which a declaration is unnecessary. [**Travers** v. **Louden** (1967) 254 CA2d 926]

*Editor's note: An important distinction must be made between a court's refusal to award declaratory relief and a declaratory judgment which is **negative** or **adverse** to the individual seeking it.*

*When an actual controversy exists, a person is entitled to declaratory relief even if the judgment is against him since he is entitled to have his uncertainty resolved.*

# Chapter 50 Rent skimming by buyers

*This chapter examines the rent skimming remedies available to sellers, lenders and tenants affected by a buyer's rent skimming activities.*

## Five or more is a crime

*Rent skimming* occurs when a buyer receives rents from a *parcel* of residential rental property during his **first year of ownership** and does not apply the rents (or an equivalent amount) to the payments due on all notes secured by the property. [Calif. Civil Code §890(a)]

A **parcel** is real estate with a single legal description containing one-or-more residential units within the boundaries of the parcel.

A buyer who rent skims from five-or-more parcels of real estate he took title to during any two year period exposes himself to penalties for *multiple acts* of rent skimming.

The **multiple act** of rent skimming from five-or-more parcels of residential rental property must occur during the buyer's first year of ownership of each parcel. The parcels subject to one count of multiple acts of rent skimming are only those acquired during **any two-year period**. [CC §890(b)]

## Skimming the rents for profit

A buyer seeks to purchase residential rental property in an effort to build an estate, but has insufficient cash savings to make a regular down payment. The buyer locates a residential property valued at $300,000, encumbered with a $260,000 first trust deed.

The seller is motivated to accept a "no-down" offer from the buyer if he can:

- sell the property at his asking price;
- earn interest income on a carryback installment sale; and
- defer profit tax reporting on the sale until the principal is paid in full or qualify for a $250,000 profit exclusion as his principal residence.

The buyer offers to enter into either a land sales contract, all-inclusive note and trust deed (AITD) or a lease-option sale with the seller, called *wrap-around financing*.

The buyer will not make a down payment on the property. However, a deferred down payment will be paid to the carryback seller through additional periodic principal payments over a three-year period.

The arrangement will defer payoff of the seller's equity in the property as part of the carryback arrangement. The seller will continue to make payments to the underlying lender with funds received from the buyer on the wraparound financing.

The purchase agreement calls for the seller to convey (or reconvey) the real estate to the buyer once all payments towards the principal have been paid.

This financing arrangement appears to match the seller's goals. The seller can convert his real estate equity into interest income and principal payments with:

- what he perceives to be a high degree of safety;
- a higher interest rate than offered on insured savings accounts; and
- apparent out-of-pocket relief from loan payments and property management.

The seller accepts the buyer's offer and the buyer takes possession of the property.

The buyer then rents the property to a tenant. However, within one year of purchasing the property, the buyer stops making payments to the seller. In turn, the seller defaults on his payments to the underlying lender since he is unable to fund the loan payments without payments from the buyer.

Due to the seller's default in payments, the underlying lender forecloses on the property and acquires it at the foreclosure sale, wiping out the seller's, buyer's and tenant's interests in the property. The buyer is not engaged in multiple (five) acts of rent skimming.

The lender, having acquired title, serves the tenant with a 30-day Notice to Quit Due to Foreclosure, and the tenant vacates the property. [See **first tuesday** Form 573]

The tenant sues the buyer, seeking to recover his security deposit and moving expenses.

Additionally, the seller sues the buyer for his money losses caused by the buyer's purchase of the property, its rental to a tenant by the buyer and the buyer's failure to pay on the carryback note during the buyer's first year of ownership, called **rent skimming activities**. The seller seeks to recover the amount of his equity still owed to him on the purchase price.

Can the tenant and the seller collect their money losses caused by the buyer's rent skimming activities which were limited to this property?

Yes! Both the tenant and the seller have separate and enforceable claims against the buyer. Each can collect their money losses caused by the buyer's rent skimming activities. [CC § 891(a), (d)]

## Tenant recovery of money

A tenant of residential property may recover actual out-of-pocket money losses from a buyer who engages in **rent skimming** which causes:

- the property to be sold at a foreclosure sale; and
- the tenant to be forced to move.

The **tenant's recovery** includes any security deposit lost, moving expenses, attorney fees and court costs.

Additionally, the tenant may collect *punitive damages* from the rent skimming buyer at three times the amount of the tenant's out-of-pocket losses if:

- payments on the underlying trust deed were at least two months delinquent at the time the tenant rented the property; or
- the buyer participated in **multiple acts** of rent skimming (five properties within two years) which involved the property. [CC §891(d)]

The tenant's recovery for rent skimming is awarded in addition to his remedies for the buyer's breach of the rental agreement. For example, under a landlord's breach of a lease, the tenant can collect lost rental value for the remaining lease period should the rent he pays on a comparable replacement residence be higher.

## Seller recovery of money

A carryback seller is entitled to his actual money losses caused by a buyer's rent skimming whether or not the buyer was involved in multiple acts of rent skimming. The **seller's recovery** includes the amount owed under a carryback note, land sales contract or lease-option — despite anti-deficiency, nonrecourse law barring recovery of money.

Additionally, the carryback seller is entitled to collect other money losses caused by the rent skimming buyer's activities, such as waste. [CC §891(a), (g)]

The carryback seller is further entitled to **punitive damages** of no less than three times his out-of-pocket losses if the buyer participated in **multiple acts** of rent skimming which involved the seller's property. [CC §891(a)]

Should the seller foreclose and bid on the property and recover ownership, he will have to underbid in the amount of his out-of-pocket losses if he is to sustain an actual loss on foreclosure.

## Deed-in-lieu protection

A **carryback seller** who reacquires the property by a *deed-in-lieu of foreclosure* from a rent skimming buyer is entitled to a court order clearing title of any judgment liens brought about by the buyer.

The alternative to a **deed-in-lieu** is to foreclose on the carryback trust deed and eliminate the junior liens by a trustee's sale.

A carryback seller who reacquires clouded title under a deed-in-lieu must give the lienholders at least 30 days advance written notice of the seller's intention to remove the liens by court order. [CC §891(b)]

## Lender recovery from buyer is limited

A lender whose loan is secured by property acquired by a buyer who is guilty of **multiple acts** of rent skimming involving the lender's secured property and other properties may recover its actual *money losses* from the buyer. However, recovery is **limited to the rents** collected on the property, whether or not the buyer assumed the loan. [CC §891(c)]

Rent recovery is separate from any recovery on the note through foreclosure. If the lender **underbids** at the trustee's sale by the amount of rents collected in order to sustain a loss on his loan, anti-deficiency law will not prevent the lender from recovering the rents up to the amount of the *loss on the underbid*.

## Rent skimming prosecution

Not only will a buyer engaged in **multiple acts** of rent skimming be liable for money losses he inflicts on the tenant, seller and lender, but the buyer exposes himself to **criminal prosecution** as well.

The crime of multiple acts of rent skimming comprises rental units acquired during a two year period. Further, prosecution for the **multiple acts** of rent skimming must be filed within three years after the last parcel involved in the multiple acts of rent skimming was acquired. [CC §892(c)]

For example, a landlord skims the rents off more than five parcels. All the properties were encumbered and acquired by the landlord within a two-year period.

The state files criminal charges on:

- the **initial act** of multiple rent skimming (rent skimming on five parcels acquired in a two-year period); and
- **additional acts** of rent skimming for each parcel not included in the five parcels establishing the initial act of multiple rent skimming.

The state files the charges within three years of the landlord's acquisition of the last of the five parcels included in the initial charge of multiple acts of rent skimming. However, while the parcels involved in the additional charges were acquired during the same two-year period covered by the initial multiple act of rent skimming, the additional parcels were not acquired within the three-year statute of limitations period for rent skimming.

The landlord claims the criminal charges cannot be brought for the additional acts of rent skimming since these were not included in the charges of multiple acts of rent skimming and he acquired those additional parcels more than three years before the state brought the action, and thus he is protected by the statute of limitations.

The state claims the prosecution of each additional violation is proper since all the charges were brought within three years after the last acquisition of a parcel subject to rent skimming, and the additional acquisitions occurred within the two-year period ending on acquisition of the last parcel.

Is the landlord subject to criminal charges for the additional acts of rent skimming for properties acquired more than three years before charges were filed?

No! The state's action for each additional rent skimming violation after the first violation (comprised of five separate acts of rent skimming within a two year period) is time-barred by the three year *statute of limitations*. The acquisition of each additional parcel which is the subject of each **additional violation** did not occur within three years prior to filing the action. [**People** v. **Bell** (1996) 45 CA4th 1030]

A buyer found guilty of five acts of rent skimming is subject to imprisonment for one year, a fine of no more than $10,000, or both imprisonment and the fine.

For each additional act of rent skimming beyond five, the buyer is subject to an additional one-year imprisonment, or $10,000 fine, or both imprisonment and the fine. [CC §892(a)]

If the buyer was previously convicted of multiple acts of rent skimming, further rent skimming will subject the buyer to one-year imprisonment, a fine of no more than $10,000, or both imprisonment and the fine for **each additional act** of rent skimming. [CC §892(b)]

The crime of multiple acts of rent skimming is considered a misdemeanor unless the court in its discretion sentences the rent skimmer to state prison. [Calif. Penal Code §17]

Consider an individual who, within a two year period, takes possession of five or more parcels of unoccupied residential property, called an *adverse possessor*. Each parcel is encumbered by a trust deed lien. The **adverse possessor** then rents the properties to tenants who take possession.

The adverse possessor collects rents during the first year of possession. No part of the rents (or other funds) are applied toward payments due on the trust deed notes.

The state claims the adverse possessor engaged in the criminal act of rent skimming since no part of the rents collected were applied toward the payments due on the trust deed note.

The adverse possessor claims he did not engage in rent skimming since he rented the unoccupied parcels as his initial step toward acquiring title.

Is the adverse possessor guilty of the crime of rent skimming?

Yes! The adverse possessor is *criminally liable* for multiple acts of rent skimming. He **took possession** of five or more parcels of real estate within a two year period which were encumbered with a loan, rented them to tenants and failed to apply the rents toward payments due on the loan. [**People** v. **Lapcheske** (1999) 73 CA4th 571]

## Buyer's defense

A rent skimming buyer may avoid rent skimming charges, both criminal and civil, if the rents were used to pay his medical expenses, or licensed contractors or material suppliers to correct violations relating to the habitability of the property, if:

- the payments are made within 30 days of receiving the rental revenue; and
- no other source of funds existed from which to make the payments. [CC §893]

Thus, to avoid rent skimming charges, buyers who become delinquent must submit to the lender the entire monthly rent they receive from tenants, limited to the delinquent and current monthly payment amounts. Typically, the lender will imprudently return the funds to the buyer, refusing to accept the rents since the amount is insufficient to fully reinstate the loan.

Consider an adverse possessor who is charged with the felony of grand theft for taking rents as a trespasser. However, the adverse possessor, like any buyer of property, is entitled to take the rents since he was in physical possession of the parcels.

Thus, an **adverse possessor** does not commit the felony of *grand theft* since his taking of the rents is not a crime. However, if he acquires five or more properties in a two year period and fails to pay the trust deed loans encumbering the properties from the rents he collects, he has committed a crime. [Lapcheske, *supra*]

## The federal scheme

Many buyers seek out desperate sellers who are in default on loans insured by the Federal Housing Administration (FHA) or Veterans Administration (VA). In these situations, the buyer acquires the property with little or no money down, then converts it to a rental unit.

For example, an investor purchases homes in default which are encumbered by FHA and VA loans. The investor rents the properties to tenants but applies none of the rents received to the underlying loans.

The investor is prosecuted for equity skimming by the federal government.

The investor claims the government cannot prosecute him unless it can show he had an intent to defraud the government.

In this federal law case, the investor need not even be aware the properties are FHA-or VA-insured in order to be convicted of rent skimming when the investor who acquires a residential property:

- rents the property;
- collects rents; and
- fails to make payments on the loans. [**United States** v. **Laykin** (9th Cir. 1989) 886 F2d 1534]

An investor will be guilty of **rent skimming** under federal law if the investor:

- purchases a one-to-four unit residential property subject to an FHA-or VA-insured loan which is in default at the time of purchase, or defaults on the loan within one year after purchase;
- intentionally fails to make payments on the loan as they become due; and
- uses the rental income for his own purposes. [12 United States Code §1709-2]

The investor may be guilty of rent skimming regardless of whether he is personally obligated on the FHA/VA loan.

However, the federal rent skimming statute does not apply to an investor who only owns one property subject to a FHA/VA loan. The investor must be guilty of **two or more acts** of rent skimming on properties subject to FHA/VA loans to be prosecuted by the federal government.

An investor found guilty of rent skimming will be subject to a fine no greater than $250,000, imprisonment for no more than five years, or both imprisonment and the fine. [12 USC §1709-2]

# Chapter 51 Getting out of litigation gracefully

*This chapter illustrates a broker's use of good faith settlement negotiations to end his liability exposure in a dispute between others.*

## Good faith settlement ends broker liability

A buyer of a condominium unit discovers the actual size of the unit is considerably less than stated by the seller's broker. The buyer accuses the seller and the seller's broker of **misrepresenting the size** of the unit. The buyer makes a demand on both the seller and the broker to recover the money paid for the nonexistent square footage.

The seller and the broker each claim the other is responsible for bringing about any misrepresentation of the square footage which lead to the buyer's loss. Thus, they seek *indemnity* from each other for any recovery against them by the buyer.

Prior to trial on the buyer's dispute, the broker **negotiates a settlement** with the buyer. The settlement is approved by the court as being entered into *in good faith*. The seller is not released by the settlement.

Later, the seller claims the broker breached his fiduciary duty owed to the seller by misrepresenting the size of the property to the buyer. The seller seeks to recover the brokerage fee paid to the broker on the sale and the attorney fees he incurred to defend against the buyer's claim.

The broker claims the seller's action for breach of fiduciary duty is merely an *indemnity claim* which is barred since his liability to the seller for further liability due to the buyer's claim was terminated by his *good faith settlement* with the buyer.

Can the seller recover anything from the broker?

No! The seller's claim against the broker for breach of the agent's fiduciary duty owed the seller to accurately disclose the property's physical condition to the buyer was barred by the broker's **good faith settlement** with the buyer, which was approved by the court. [**Cal-Jones Properties** v. **Evans Pacific Corporation** (1989) 216 CA3d 324]

*Indemnity* is an obligation imposed on one individual, such as a broker, and owed to another individual, such as a seller, to pay a loss incurred by a third person, such as a buyer. The obligation is commonly referred to as a *hold harmless arrangement*.

An **indemnity** provision can be written into a contract, as is the case with a title insurance policy, or arises as part of a *special relationship*, such as exists between an agent and his client under a listing agreement.

A claim for indemnity arises between two individuals when one of the individuals is sued by someone else to recover losses caused by the other individual — such as the previous example where a buyer sues a seller and the seller claims the broker caused the buyer's loss. This results in a demand for *equitable indemnity* since the claim for indemnity is not covered by a contract provision.

For instance, claims for **equitable indemnity** frequently arise between builders and subcontractors in litigation over construction defects where their subcontract does not contain an indemnity provision. If the owner of the defectively constructed property makes a demand on the builder for the costs incurred to correct the defects, and the builder in turn makes a demand on the subcontractor to pay the loss, claiming it was actually caused by the faulty work of the subcontractor, the builder is seeking indemnity from the subcontractor for the claims made on the builder by the property owner.

### Buyer and seller held harmless by broker

In real estate sales, disputes between buyers and sellers typically expose the brokers who negotiated the sales transaction to claims for **equitable indemnity** based on their involvement as agents in the transaction. However, no agreements entered into by brokers contain an indemnity provision, called a *hold harmless agreement*.

A broker's **good faith settlement** of his involvement in a lawsuit between a buyer and a seller allows the broker to escape further liability to either the buyer or seller on the dispute. The settlement ends all liability of the broker to others in the litigation who may still be held liable to the individual who settled with the broker. [Calif. Code of Civil Procedure §877.6]

The broker's client in the previous square footage dispute pursued an agency law claim against his broker for a breach of his fiduciary duty, rather than an indemnity claim which was terminated by the good faith settlement.

However, an indemnity claim against a broker who acts as an agent in a transaction for the person seeking indemnity is based on an agency claim — the failure of the broker to correctly advise or represent his client — which caused someone in the transaction to sustain a loss recoverable from the broker's client. Specifically, the broker's advice or representations **exposed his client to liability** under agency law.

The claim of the seller in the square footage case to recover his costs of further litigation from his broker is fundamentally an action for indemnity against the broker, no matter how the claim is worded. The seller's claim against the broker is triggered by the buyer's claim, since the seller would not have suffered a loss were it not for the buyer's lawsuit.

Thus, the seller was trying to **reestablish the broker's liability** for the same losses incurred by the buyer which were the subject of the court-approved good faith settlement between the broker and the buyer which terminated the broker's further liability.

To determine whether a settlement is made in good faith, the settlement amount must be within the reasonable range of the settling party's *proportional liability* based on the facts known at the time of the settlement. [**Far West Financial Corporation** v. **D & S Company, Inc.** (1988) 46 C3d 796]

The **apportionment of liability** — a percentage of fault imposed on the broker for the loss — is the same for the broker whether he first settles (for less money), or later reimburses the loser under an indemnity claim (for more money).

A court hearing that determines the broker's settlement with the buyer was in good faith was the **seller's last opportunity** to pursue his indemnity claim against the broker. Only a separate dispute between the broker and the seller, in which no one other than the **seller suffered a loss** as a result of the broker's actions, survives a court-approved good faith settlement between the broker and the buyer.

Any claim of the seller against the broker which is independent of the loss suffered by the buyer and uninvolved with the broker's good faith settlement with the buyer exposes the broker to continued liability since no aspect of the seller's claim relates to any losses suffered by the buyer.

Thus, a good faith settlement allows the broker to prudently get out of litigation early and for a reasonable price, and proceed with his life and business — except for direct losses incurred only by the client at the fault of the broker.

# Chapter 52 Attorney fees reimbursed

*This chapter discusses the recovery of attorney fees incurred to prevail in real estate disputes.*

### By agreement, by statute or by both

Consider an owner who signs a promissory note in favor of a private lender to evidence a debt. The debt is secured by a trust deed on real estate.

The note provides for the owner to pay attorney fees incurred by the lender on an *action to enforce the note. Thus, the* ***attorney fees provision***:

- limits recovery to actions on the contract, not negligence of other tort actions; and
- is one-sided in its application — enforceable by the lender only. [See Figure 1]

The lender **making** the loan is not licensed as a real estate broker. Also, a real estate broker is not consulted to **arrange** the loan. Thus, the loan is controlled by the *usury ceiling* on the annual yield received by the lender over the life of the loan, such as interest, discounts and bonuses. [Calif. Constitution, Article XV §1]

However, the interest yield agreed to by the owner exceeds the **usury ceiling** (the Federal Reserve Board of San Francisco discount rate, plus 5% with a 10% floor). Thus, the loan is usurious and only the principal amount advanced can be collected by the lender.

The owner discovers the loan is usurious and tenders only the amount the lender would be legally able to collect — the remaining principal, less all interest and discounts paid.

The lender rejects tender of the adjusted principal and statutory reconveyance costs and initiates foreclosure to enforce the note. To protect himself against the loss of his property, the owner files a lawsuit claiming usury as a defense to the lender's attempts to foreclose on his property.

The loan is held to be usurious. The owner, having prevailed, demands payment of his attorney fees from the defeated lender under the attorney fees provision in the note.

The lender claims he owes no attorney fees since he never agreed in the attorney fees provision to pay the owner's attorney fees; under the provision, only the owner agreed to pay the lender's attorney fees.

Is the lender liable for the owner's attorney fees?

Yes! The **existence** in the note of an attorney fees provision for enforcement of the note entitles the *prevailing party* to be awarded his attorney fees from the loser, even if the provision is written to protect only the lender. [Calif. Civil Code §1717; **Winnett** v. **Roberts** (1986) 179 CA3d 909]

Conversely, had the private lender successfully enforced his note against the owner's usury defense, the lender would have been entitled to reimbursement of his attorney fees from the owner.

## Paying the attorney

Each party to a lawsuit must bear the burden of his own attorney fees unless a **statute**, or the **agreement** out of which the dispute arose, calls for an award of attorney fees to the prevailing party. [Calif. Code of Civil Procedure §1021]

Additionally, a claim by an individual, such as a broker, for *indemnity* to require another person, such as a seller, to hold the individual harmless in litigation initiated by a third person, such as a buyer, and involving the individual is another basis for collecting attorney fees.

Paying your own attorney fees is a tradition in American law. Conversely, the English common law entitles the winning party to be paid his attorney fees by the loser. [**Reynolds Metals Company** v. **Alperson** (1979) 25 C3d 124]

With attorney rates per hour far exceeding the average daily pay received by the typical household, and contingency fee arrangements exceeding one-third of the money/value recovered, the cost of litigation is an **economic factor** which weighs on the resolution of any dispute.

Accordingly, it is financially essential that a broker confronted with a claim understand when and how attorney fees can be collected (or paid), either by themselves or by others.

### Real estate practices for attorney fees

Real estate agreements which typically contain an **attorney fees provision** include:

- listings;
- purchase and exchange agreements;
- escrow instructions;
- leases and rental agreements; and
- promissory notes and trust deeds.

Those who have the most to benefit from an attorney fees provision include landlords in lease agreements, lenders in promissory notes and brokers in listing agreements. These are the entities most likely to **sue and prevail** on these agreements.

**Figure 1**

"If an action is instituted to enforce this note, I promise to pay such sum as the court may fix as attorney fees."

**Figure 2**

"In any action to enforce this agreement, the prevailing party is to receive reasonable attorney fees."

**Figure 3**

"In any action arising out of this agreement, the prevailing party is to receive attorney fees."

Additionally, these classes of litigants are likely to want the attorney fees provisions to be worded to limit recovery of attorney fees to actions for **enforcement** of the lease, note or listing. Thus, they get attorney fees if they win, or the person sued gets attorney fees for defending.

However, the persons sued on a contract with an attorney fee provision limiting recovery of enforcement cannot collect their attorney fees on any action they pursue on a tort theory which **arises out of the contract**, such as misrepresentation or breach of agency duties, which are claims often raised by those defending against a lawsuit. [See Figure 2]

## To use or not to use

Purchase agreements entered into by buyers and sellers exist in a litigation-prone environment. As a result, brokers should consider excluding attorney fees provisions from some agreements as a **risk reduction strategy** to avoid inducing litigation between others in which they become entangled.

For example, the California Association of Realtors' purchase agreement form contains an attorney fees provision (as well as the publicly unacceptable compulsory arbitration agreement).

Conversely, neither an attorney fees provision nor an arbitration agreement is included in any of the purchase agreement forms published by **first tuesday**.

The difference is significant.

For buyers and sellers, attorney fees provisions tend to encourage and promote litigation rather than inhibit it. Unfortunately, when buyers and sellers sue one another over a transaction, brokers are uniformly named as defendants who are at least claimed to owe a duty to indemnify.

The absence of an attorney fees provision in purchase agreements appropriately focuses the dispute on the **monetary recovery** available, an amount limited to actual money losses on a transaction. Thus, any money award recovered would be reduced by the attorney fees paid to pursue the recovery.

As a result, a dispute between a buyer and a seller will not proceed to litigation if the recovery of the money losses will be **economically infeasible** to pursue except for the additional recovery of attorney fees, an unintended but real consequence of the provision. Thus, the risk of a broker's entanglement in litigation between buyers and sellers is reduced by eliminating the attorney fees provisions from purchase agreement forms.

Without an attorney fees provision, the buyer or seller must be fully convinced they will prevail against the other, and are willing to pay and bear the ultimate cost of their own attorney fees from any recovery.

## Who benefits by ability to recover fees

At first glance, attorney fees provisions inserted in purchase agreements appear to only benefit the fortuitous attorneys who will represent the parties.

However, real estate attorneys generally do not take cases involving real estate disputes on contingency fee arrangements. Rather, they are paid based on an hourly rate. On retaining an attorney, the client is required to sign an attorney fee agreement, which itself contains an attorney fees provision.

The deposit of an upfront retainer, against which the attorney will bill his time, is almost always demanded by the attorney.

Clients who do not pay their attorney by either depositing a minimum balance with them, or paying billings on time, will find their attorney successfully requesting the court for a withdrawal from the case. [**People** v. **Prince** (1968) 268 CA2d 398]

Accordingly, experienced attorneys retained on real estate matters assure themselves from the outset of a transaction that they will be paid for their services by their client.

Thus, attorney fees provisions can hardly be said to benefit attorneys, other than to induce them to incite their client to litigate based on their expectation of winning.

On the contrary, attorney fees provisions are designed to **reimburse the winner** — as the beneficiary of the provision — on successful completion of the litigation by trial. If the litigation is terminated by a voluntary dismissal or settlement, no one collects attorney fees.

The presence (or absence) of an attorney fees provision in a contract plays a significant role in the eagerness with which individuals pursue, defend or avoid legal disputes.

## Agreed-to attorney fees

Any agreement containing an attorney fees provision entitles the prevailing party to reimbursement of attorney fees they incurred *enforcing* the contract, regardless of how the provision is worded. [CC §1717(a)]

This **reciprocal fee statute** applies to actions on the contract only, not tort actions such as misrepresentation, deceit or breach of agency duties.

An attorney fees provision in an agreement is read to apply reciprocally for all parties to the agreement to collect attorney fees on any action based on the contract. Simply, if an attorney fees provision exists, the prevailing party at trial receives his attorney fees in contract disputes, limited only by reasonableness, the wording of the fee provision and the application of the reciprocal fee statute. [**Smith** v. **Krueger** (1983) 150 CA3d 752]

## Only reasonable fees

The losing party does not necessarily **pay all** of the prevailing party's attorney fees under an attorney fees provision — only the fees which the court deems **reasonable**.

Courts have a great deal of discretion in deciding what is reasonable and may consider:

- the complexity of the litigation;
- attorney rates for similar cases in the area;
- the prevailing attorney's experience, knowledge and skill;
- the time properly consumed by the case; and
- the amount of the final judgment. [**Clejan** v. **Reisman** (1970) 5 CA3d 224]

Many agreements include the word "reasonable" in the language of the attorney fees provision. [See Figure 2]

Even if the attorney fees provision does not state "reasonable attorney fees," **reasonable fees are implied**. [See Figure 1 and Figure 3]

Attorney fees are assessed and collectable only after a judgment becomes final and ends the litigation. The prevailing party must ask the court for the fees or submit the attorney fees as part of the court costs to be recovered. [CCP §1021]

Either way, a copy of all billings for legal services is submitted to the court as evidence of the prevailing party's attorney fees. The losing party will likely object to the costs as "unreasonable."

If the prevailing party's actual attorney fees exceed what the court deems reasonable, he is not reimbursed for the excessive fees paid or demanded by his attorney. Fees in excess of a reasonable amount are borne by the prevailing party.

### Who is the prevailing party?

The **prevailing party**, determined when the court enters its final judgment in the case, is the individual who:

- receives the greater money damages award [CC §1717(b)(1)];
- receives the requested equitable relief (a non-money remedy, such as specific performance); or
- successfully defends against the plaintiff's claim and the plaintiff obtains no relief. [CCP §1032(a)(4)]

For example, a group of tenants sue their landlord for a breach of their leases. The leases contain an attorney fees provision.

When the tenants withhold rent payments, the landlord files an unlawful detainer (UD) action to evict the tenants. The tenants' action and the landlord's UD action are consolidated into one lawsuit.

The tenants prevail on their claim that the landlord breached their lease agreements and they are awarded a money judgment. However, the landlord is also awarded a money judgment against the same tenants for the delinquent rent. A setoff then occurs between the greater and the lesser amounts of the two opposing money awards.

The money judgment awarded to the tenants is greater than the amount of the landlord's judgment. Both the landlord and the tenants claim their attorney fees are owed since each prevailed on their respective claims.

Who is the prevailing party: the landlord, the tenants or both?

In this instance, the tenants prevail for purposes of recovering attorney fees under the lease since the tenants received a higher dollar amount of recovery then the landlord. [**Haire** v. **Stevenson** (1987) 196 CA3d 1249]

However, a court has the discretion to decide neither party prevailed. For example, when the money recovery by both parties is comparable or so small that neither party is the winner, the court can deny the payment of attorney fees. [CC §1717(b)(1)]

Additionally, when a case is **voluntarily dismissed** or **dismissed pursuant to a settlement**, neither party prevails for attorney fees purposes. [CC §1717(b)(2)]

### On the contract or arising from it

A client's attorney pursues recovery based on numerous theories and causes of action, some in *contract* to enforce an agreement, some in *tort* to recover for bad conduct.

For example, a buyer sues his seller alleging intentional misrepresentation, negligence, **breach of contract** and agency duties, indemnity and even emotional distress in an effort to recover his loss of money on the purchase.

Each legal theory for recovery is a separately stated claim for recovery, some to enforce the **contract**, some based on the seller's conduct, called **torts**. The buyer's attorney spends billable time researching, investigating and establishing proof for each claim the buyer is making.

The purchase agreement used by the buyer to document the transaction contains an attorney fees provision covering all litigation **arising out of the subject** of the agreement, not limited to litigation enforcing the contract. [See Figure 3]

In this instance, the prevailing party can recover attorney fees for the billable time spent on every claim he prevails on which arises out of the **subject matter** of the agreement which contains the attorney fees provision — not just for the fees incurred on claims seeking to *enforce* the purchase agreement, such as specific performance.

Claims other than for enforcement or the recovery of money losses under a breached purchase agreement (specific performance or lost value) arise due to a person's improper conduct and are personal under *tort theories*, including breach of fiduciary duties, breach of covenants for good faith and fair dealing and fraudulent representation, deceit or concealment. [**3250 Wilshire Boulevard Building** v. **W.R. Grace & Company** (9th Cir. 1993) 990 F2d 487]

## The listing and attorney fees provisions

Consider the recovery of attorney fees incurred by a client who pursues a *fraud or negligence* action against a broker arising out of his employment under a listing agreement. The recovery of the attorney fees by either party will depend on the type of attorney fees provision contained in the listing agreement.

For example, a broker employed by a buyer under a listing agreement fails to include key terms from a purchase agreement in the escrow instructions. The attorney fees provision is all-inclusive since it calls for reimbursement of attorney fees in **any action arising** out of the listing contract. [See Figure 3]

The buyer sues the broker for both neglect and breach of the listing agreement.

The buyer wins a money judgment against the broker for his negligent conduct as an agent of the buyer and demands his attorney fees under the attorney fees provision in the listing agreement.

The broker claims he owes no attorney fees since his negligence while acting as an agent was the basis for the client's recovery, not a dispute regarding a breach or performance of the listing agreement.

Is the buyer entitled to receive attorney fees?

Yes! The attorney fees provision in the agreement was not limited to recovery based solely on enforcement of the listing agreement. The broker's negligence as an agent **arose out** of his employment agreed to in the listing agreement, which is an action covered by the "all-inclusive" attorney fees provision.

The broker's negligent acts as an agent while handling the sale of the listed property is not a separate and distinctly different activity from the employment undertaken in the listing agreement to locate a buyer for the property. The neglect occurred as a result of the employment. [**Perry** v. **Robertson** (1988) 201 CA3d 333]

However, the broker would not have been liable for attorney fees for his negligent conduct had the attorney fees provision limited recovery to enforcement of the listing agreement. [See Figure 2]

## Buyer's broker and no attorney fee provision

Now consider a buyer and seller who enter into a purchase agreement on a form which separates the seller's agreement to pay a brokerage fee from the purchase agreement signed by the buyer. The **separate brokerage fee agreement** is signed by the seller, but not the buyer. Thus, the brokerage fee is not provided for within the terms of the purchase agreement.

However, the buyer's purchase agreement includes an attorney fees provision covering any dispute between the parties to the purchase agreement.

Later, the buyer sues the broker for misrepresentation. The broker retains an attorney and prevails against the buyer.

The broker claims he is entitled to recover his attorney fees from the buyer since he received a fee on the sales transaction which was documented by a purchase agreement "containing" an attorney fees provision.

In this example, the broker is not entitled to recover his attorney fees. The broker's only right to a brokerage fee is derived from the separate brokerage fee agreement entered into by the seller to which the buyer was never a party.

Thus, the broker cannot benefit from the attorney fees provision in the purchase agreement since the provision for payment of a brokerage fee was not agreed to by the buyer. The attorney fees provision was part of the seller's separate brokerage fee agreement, not the buyer's purchase agreement entered into by the buyer. [**Super 7 Motel Associates** v. **Wang** (1993) 16 CA4th 541]

## Unenforceable agreements

A buyer and seller enter into a real estate purchase agreement containing an attorney fees provision. The buyer and seller become embroiled in a dispute over a contingency and the seller cancels the transaction.

The buyer sues the seller for specific performance of the purchase agreement. However, the buyer loses since the terms of the purchase agreement are too ambiguous for the court to determine what the parties agreed to or how to enforce the agreement.

As the prevailing party, the seller makes a demand on the buyer for payment of his attorney fees. The buyer claims attorney fees are not owed since the **agreement is unenforceable**.

Is the seller entitled to recover his attorney fees from the buyer?

Yes! The judgment in favor of the seller is **on an agreement**, although unenforceable, which contains an attorney fees provision. [**Manier** v. **Anaheim Business Center Company** (1984) 161 CA3d 503]

Now consider a buyer and seller who enter into a purchase agreement.

Before closing, the seller's broker obtains a **backup offer** from another buyer to purchase the same property if the first transaction with the original buyer is terminated.

Both purchase agreements for both buyers contain attorney fees provisions.

The first transaction with the original buyer is *renegotiated* and totally restructured by the seller and the buyer. As a result, the renegotiated agreement has an entirely different set of terms and conditions than the original agreement. The first transaction with the original buyer, as renegotiated, closes.

The backup buyer claims the renegotiated transaction the seller actually closed on with the original buyer is a new and later agreement, not the prior agreement on which his backup transaction was contingent. Thus, the backup buyer claims the contingency no longer exists and the backup agreement now has priority and is enforceable.

The backup buyer sues the seller and the original buyer to enforce his backup purchase agreement and acquire ownership of the property.

However, the original buyer prevails. Additionally, the original buyer claims the backup buyer owes him the attorney fees he incurred defending against an attempt to enforce the backup buyer's purchase agreement.

The backup buyer claims he does not owe attorney fees to the original buyer since the original buyer was not a party to the backup purchase agreement which was litigated.

Does the original buyer, who was not a party to the unenforceable backup purchase agreement, receive his attorney fees?

Yes! The backup buyer sued the original buyer **to enforce an agreement** containing an attorney fees provision. The original buyer, now the owner, successfully defended his ownership of the property against the claim to ownership made under the backup contract. Conversely, had the backup buyer prevailed, he would have received his attorney fees since the original buyer had become the successor to the seller with knowledge of the backup sales agreement. [**Meadows** v. **Lee** (1985) 175 CA3d 475]

### Attorney fees on an assumed loan

A buyer takes title to real estate subject to an existing first trust deed. The lender, aware of the transfer, **calls** the loan. Much later and after accepting installments without first entering into a loan assumption agreement with the buyer, the lender initiates foreclosure due to the tandem effect of the due-on-sale and acceleration clause in the trust deed.

Both the note and the trust deed contain an attorney fees provision. The buyer sues the lender to stop enforcement of the call under the due-on-sale and acceleration clause and **prevails** — the lender waived its right to foreclose by accepting payments after the call.

The buyer then makes a demand on the lender for attorney fees incurred to enforce his rights under the lender's note and trust deed.

The lender claims the buyer cannot collect attorney fees since he did not sign or formally assume the note and trust deed. Thus, the buyer is **not a party** to the trust deed contract being litigated.

Can the buyer collect his attorney fees even though he never signed or formally assumed the existing loan?

Yes! Attorney fees are payable to the prevailing party, in this example the buyer, in a dispute enforcing an agreement containing an attorney fees provision. An agreement containing an attorney fees provision *does not need to be signed* by either party for the prevailing party to collect attorney fees. [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

## By statute or by court order

In addition to collecting attorney fees under an attorney fees provision in a contract, the prevailing party in some real estate disputes is entitled to recover his attorney fees under a statute or by a court-created right.

For example, a water district maintains a canal system to collect excess water from one basin and divert it into a neighboring water basin.

The diverted water floods an owner's property. The property owner sues the water district to recover the fair market value (FMV) of his property under his federal constitutional right to just compensation for a *taking* by a government agency, legally called *inverse condemnation*.

The owner claims the water district has **taken** his property by physically occupying it with flood water, as though the water district has formally condemned the property through **inverse condemnation** for its own use to store excess water.

The water district claims the physical occupation of the owner's property by its flood waters is not a taking and only inflicts flood damage to the property. The owner wins his inverse condemnation action forcing the water district to pay him the full cash value of his flooded property.

The owner demands reimbursement of his attorney fees spent pursuing his claim against the water district.

The water district claims the owner has no right to reimbursement of attorney fees since the United States Constitution makes no mention of attorney fees as a part of recovery under the **just compensation** clause.

However, the owner claims the attorney fees are collectable under California **statutory** recovery of attorney fees in condemnation actions. [CCP §1036]

Is the owner of the flooded property entitled to reimbursement of his attorney fees spent on his condemnation action?

Yes! The California Legislature created the right to collect attorney fees in **taking actions**, even though the federal constitutional right to recover the property's value contains no mention of the payment of attorney fees. [**Salton Bay Marina, Inc.** v. **Imperial Irrigation District** (1985) 172 CA3d 914]

However, had the flooding only damaged the property and not been a taking of the real estate, no attorney fees would be owed since no statute exists for the reimbursement of attorney fees in real estate damage cases.

*Eminent domain* actions are often initiated by government agencies to take property from an owner and then compensate him for his property's value. If a property owner challenges the **eminent domain** action based on its legitimacy or the price the government agency offers to pay, the property owner is entitled to reimbursement of his attorney fees if he prevails. [CCP §1250.410]

However, consider a government agency which seeks a pre-trial settlement conference to negotiate the amount of compensation owed to a property owner in an eminent domain action.

The owner refuses to negotiate the compensation amount and demands a trial despite the government agency's willingness to compromise.

The owner prevails at trial but is not entitled to attorney fees since the trial was *frivolous and unnecessary*. The owner could have negotiated and settled the issue with the government agency in a pre-trial conference. [**Glendale Redevelopment Agency** v. **Parks** (1993) 18 CA4th 1409]

Mobilehome park rent increases and termination of lease/rental agreements are controlled by the **Mobilehome Residency Law**. This landlord/tenant law controlling mobilehomes entitles the prevailing party to attorney fees, whether the prevailing party is the landlord or the tenant. [CC §798.85]

### Civil rights violations

Similarly, real estate owners who have had their civil rights violated can collect their attorney fees by statute.

For example, an owner of an adult theater is forced to shut down his business due to the city's excessively restrictive zoning ordinances.

The owner sues the city and wins since the ordinances violate federal First Amendment rights to free speech under the United States Constitution.

The owner is entitled to collect his attorney fees from the city, even though the First Amendment does not contain any mention of attorney fees.

Additionally, a federal code permits the collection of attorney fees for violation of civil rights. [42 United States Code §1983]

### Partition actions

Consider attorney fees expended in disputes between vested co-owners of real estate to partition or sell the real estate. The co-owners cannot mutually agree on its management or disposal and have no partnership or limited liability company (LLC) agreement providing for resolution by a vote among the co-owners.

One of the co-owners incurs attorney fees for the benefit of all co-owners involved. Thus, in the judicial sale or parceling of the property, those **attorney fees** are recoverable pro rata from the other co-owners. [CCP §874.010]

Since they all benefitted from the litigation, the **contributions by all co-owners** for attorney fees is proportional to each owner's percentage of ownership interest in the real estate. [**Stutz** v. **Davis** (1981) 122 CA3d 1]

### Another's wrong — indemnity for fees

Even without a statute or contract provision addressing attorney fees, an individual prevailing in real estate litigation may have a **court-created right** to recover his attorney fees.

Consider a buyer who makes an offer to purchase an improved lot on which he will build a home. The seller's broker erroneously advises the buyer his offer has been accepted by the seller and the transaction will close within 30 days.

As a result, the buyer spends money in reliance on the broker's erroneous representation regarding the existence of a binding purchase agreement.

After the buyer is advised he has no enforceable deal, he sues the seller for specific performance and the broker for negligent misrepresentation.

The buyer loses his specific performance action against the seller, but prevails against the broker for misrepresenting that the seller had accepted the purchase offer.

The buyer makes a demand on the broker for his attorney fees incurred in the action against the seller, claiming he would not have sued the seller had the broker properly advised him on whether a binding agreement existed.

Is the broker liable for the buyer's attorney fees for the action against the seller?

Yes! Attorney fees can be recovered from an individual, called *indemnity*, when the individual's wrongful conduct (in this example the broker's) forces someone (in this example the buyer) to bring or defend a lawsuit against another person (in this example the seller). [**Gray** v. **Don Miller & Associates, Inc.** (1984) 35 C3d 498]

Further, the seller also can collect attorney fees from the broker under either the attorney fees provision in the seller's listing agreement he entered into with the broker or the indemnity theory.

### Benefits offset an award of fees

A broker negotiates the sale of an apartment building he has managed for a long time. The broker is aware of property defects, but fails to disclose these defects to the buyer.

As a result, the buyer pays the seller more for the apartment building than its present value. Thus, the seller who employed the broker receives a **higher sales price** than he should have received considering the property's condition.

The buyer, on discovering the property defects, sues the seller and the broker to recover the excess price paid for the property. The buyer obtains a money judgment against the broker, not the seller, for the amount he paid in excess of the property's fair market value (FMV).

Further, the seller also demands the broker reimburse him for his attorney fees incurred in his successful defense of the buyer's lawsuit, claiming the broker's failure to disclose the property's condition caused the litigation and therefore entitles him to *indemnity* from the broker due to their client/broker relationship.

The broker admits he owes attorney fees to the seller but claims he is entitled to an *offset* against the seller's attorney fees for benefits conferred on the seller by the broker's actions. The dollar **offset** would be the portion of the sales price received by the seller that exceeds the property's FMV.

Since the excess in the sales price is greater than the amount of the seller's attorney fees, the broker claims no reimbursement is due to the seller.

Does the broker owe the seller his attorney fees in spite of the benefits received and retained by the seller due to the broker's wrongful conduct?

Yes and no! The broker is liable for the seller's attorney fees since the broker caused the seller to have to defend against a lawsuit filed by the buyer.

However, the amount owed in attorney fees is reduced — offset — by the excess financial benefit the seller received and retained due to the broker's wrongful conduct. The right to reimbursement for attorney fees incurred due to the wrongful conduct of a broker is subject to a full offset for any **excess benefit derived** by the client from the client/broker relationship. Thus, due to the offset, the broker is left owing nothing to the seller. [**Heckert** v. **MacDonald** (1989) 208 CA3d 832]

### Other court-created rights to attorney fees

Attorney fees can also be recovered as part of an action or actions against an individual or entity involving all similarly situated persons, called a *class action*, by such individuals as tenants, borrowers, insureds, buyers, clients, etc.

Legal theories to collect attorney fees in **class action** cases include:

- *common fund* recovery for numerous injured parties;
- *substantial benefit* conferred on a group; and
- benefits conferred on a broad class of people involving a matter of strong *public policy*.

Under the **common fund** theory, the person initiating an action must obtain a judgment which benefits a group of persons, such as multiple tenants of a landlord.

In the interest of fairness, the tenant suing and obtaining a money judgment on behalf of himself and all other tenants is entitled to have his attorney fees paid out of the "fund" of monies received from the landlord. [**Quinn** v. **State** (1975) 15 C3d 162]

Consider a city which establishes an assessment district to improve streets. A citizen's group sues the city to prepare an environmental impact report (EIR) before the work can be started.

The citizen's group prevails since an EIR is required as the project substantially affects the environment.

Is the citizen's group entitled to attorney fees from the city?

Yes! The EIR **substantially benefitted** a large group of people and is an important interpretation of environmental law. [**Friends of "B" Street** v. **City of Hayward** (1980) 106 CA3d 988]

Finally, when a party sues and obtains a judgment which affects a large group of people involving a matter of strong **public policy**, the party suing recovers his attorney fees.

For example, a citizen's group enters a shopping center to obtain signatures on a statewide political issue. The owner of the shopping center prohibits the citizen's group from entering the premises.

The citizen's group sues the owner, claiming there was a violation of their First Amendment rights to free speech under the California Constitution. The citizen's group prevails and demands their attorney fees.

The shopping center owner claims no contract or statute entitles the citizen's group to be paid their attorney fees.

The citizen's group claims the case is of such importance to the whole of society that it is a matter of public policy and their attorney fees must be paid. [CCP §1021.5]

Is the citizen's group entitled to have their attorney fees paid by the shopping center owner?

Yes! The citizen's group's case sets strong public policy since it **benefitted the public** as a whole, as if the Attorney General for the State of California had brought the suit on behalf of the people. Thus, the citizen's group is entitled to recover their attorney fees. [**Press** v. **Lucky Stores, Inc.** (1983) 34 C3d 311]

A private citizen who is awarded attorney fees in a public policy case is called a *private attorney general*. [**Serrano** v. **Priest** (1977) 20 C3d 25]

# Chapter 53 Retaining a real estate attorney

*This chapter reviews the process for locating, interviewing and retaining an attorney to advise and render services in real estate disputes confronting brokers.*

## Choosing the right one

A broker is faced with a dispute arising out of a real estate transaction and requiring advice from an attorney with legal expertise in the analysis and resolution of real estate conflicts.

The broker has never sought out the professional advice of an attorney and does not know how to go about locating or selecting a qualified one.

What steps should the broker take to select a competent attorney? What law office procedure should he look for when first meeting with an attorney? What can he expect to encounter when retaining an attorney?

These questions are reviewed with suggestions and activities to be considered when seeking out and comparing the services of an attorney who specializes in real estate related disputes.

## Selecting an attorney

To initiate the attorney **selection process**, the broker should talk to several active real estate brokers in the location of the real estate which would be involved in any litigation. The brokers should be asked for the names of three or four real estate attorneys they are familiar with and feel confident referring someone to for advice on real estate and agency matters, especially of the type confronting the broker.

The broker should further inquire into the different areas of real estate law each attorney appears to be engaged in, the types of cases they handle and the competence demonstrated by the attorney as observed by the brokers he contacts. The recurrence of the name of one attorney who is consistently recommended by the brokers contacted is generally a helpful indication of the most qualified attorney.

While attorney referral services and media advertising may be helpful in the initial selection stage, it is difficult to obtain objective recommendations or criticism from these typically biased sources.

It may even be necessary to locate an out-of-area attorney who specializes in the particular type of legal situation confronting the broker due to the sensitivity of local attorneys.

Regardless of locale, at least two or more attorneys should be selected and a phone or office conference should be arranged.

Before (and after) selecting an attorney, it is both proper and prudent for the broker to contact yet another attorney and hold a telephone conference as a "brainstorming session." This would provide a second opinion — and an additional or alternative advisor. The cost of conferencing with another attorney should be considered the premium paid for assurance the broker and his selected attorney are on the right track, called *risk reduction*.

## A client's expectations

When meeting with an attorney, the broker should consider many aspects of the attorney's law office, including:

- the compatibility of the attorney's personality with his own;
- the attorney's conversational skills;
- the efficiency and professionalism of the attorney's work habits;
- the law office's appearance (for example, does it appear organized and well equipped?);
- the courtesy, productivity and helpfulness of the secretarial staff; and
- the competency of the attorney's law clerks or legal assistants to follow up on fact investigation, legal research, calendaring of events and related details.

## The initial conference

During the initial conference with the selected attorney, the broker will discuss his real estate dispute as well as interview the attorney. This contact is the initial step to determine whether or not the broker feels this attorney is the best one for him to retain.

Relevant topics which should be discussed during the initial interview include:

- the attorney's professional background and the types of legal disputes which make up his practice;
- the attorney's previous experience with cases similar to the broker's;
- whether his practice regularly calls for his appearance in the court which will hear the broker's case;
- the attorney's initial grasp and assessment of the facts and laws controlling the case;
- the outlook or probability of prevailing in the case;
- the different procedural stages, including negotiations, filing, discovery, trial and possible appeal;
- whether the dispute is covered by any insurance policies held by the broker;
- the potential liability exposure on an adverse result of the litigation;
- whether the prevailing party can collect his attorney fees from the other party;
- the attorney's hourly fee and required **retainer deposit**;
- the estimated cost of handling the various stages in the resolution of the dispute; and
- the tax reporting permitted for the payment of the attorney fees.

At the same time, the attorney will also be deciding whether or not he wants to represent the broker.

Additionally, bearing on the broker's decision to retain the attorney are factors including:

- the attorney's own knowledge and experience with this particular type of case, and his rapport with the broker;
- whether or not, and why, the attorney believes he can obtain a favorable result for the broker; and
- whether the attorney has a conflict based on his other cases and clients.

The broker will typically be billed for this initial consultation on a per hour basis.

Attorneys' hourly rates generally range from $150 to $400 per hour, depending on their location and expertise. Any time spent counseling with the attorney will cost the broker money.

The broker must also determine whether the attorney will handle the case himself or delegate the analysis and decision-making process to a subordinate or partner.

If delegated, to whom and how closely will the attorney supervise the handling of the case?

The broker also needs to interview any associate attorney who will work on or actually handle his case. A prudent broker will include any associate attorney in the conference to avoid double billing.

The broker must be certain the attorney or associate he is going to employ has the broker's best interests in mind.

An attorney has the basic duty to respond promptly to any status inquiries by the broker and keep the broker reasonably well informed, monthly if possible, on matters relating to the case. [Calif. Business and Professions Code §6068(m)]

If the attorney interviewed is not retained to represent the broker, the attorney still has the duty to maintain confidentiality of the information exchanged between him and the broker. [Bus & P C §6068(e)]

## Retainer agreements

Once an attorney has been chosen, the broker will be asked by the attorney to enter into a *retainer agreement* employing the attorney. The attorney has a statutory right to collect a fee for his legal services. [Calif. Code of Civil Procedure §1021]

The attorney should fully explain the amount of fees or basis for their computation before the fee agreement is signed by the broker. To be enforceable, fee agreements for attorney services must be in writing when it is known the attorney fees will exceed $1,000. [Bus & P C §6148(a)]

Thus, written **retainer agreements** must contain:

- the hourly rate and other rates, fees and applicable charges;
- the nature of the services to be provided; and
- the respective responsibilities of the attorney and broker in performance of the retainer agreement. [Bus & P C §6148(a)(1-3)]

All billings for services must be itemized by naming the activity performed, clearly state the amount due and contain the hourly rate or basis of calculation used to determine the fees. [Bus & P C §6148(b)]

If a *contingency fee* agreement is negotiated, the agreement must be in writing and contain:

- a statement of the **contingency fee** rate;
- a statement addressing how disbursements and costs incurred in connection with prosecuting or settling the case will affect the amount of the contingency fee and the broker's recovery;
- a statement addressing what extent, if any, the broker could be required to pay attorney fees for related matters not covered in the fee agreement; and
- a statement the fee is negotiable and not set by law. [Bus & P C §6147(a)(1-4)]

A duplicate copy of the contingency fee agreement signed by the attorney and broker must be given to the broker. Failure to provide this information will render the retainer agreement voidable at the option of the broker. [Bus & P C §6147(b)]

Later, if the broker has grounds and chooses to void the contingency fee agreement, the attorney will be entitled to collect a reasonable fee from the broker based on the time spent on the case. [Bus & P C §§6147(b), 6148(c)]

The retainer agreement can also be signed by and given to a representative of the broker, such as his office manager. [Bus & P C §6147(a)]

Written fee agreements are confidential contracts between the attorney and his client, in this example the broker. [Bus & P C §6149]

### Deductibility of legal fees

Deductibility of legal fees for tax reporting is determined by the activity causing the expense. If not deductible, the legal fees are either **personal losses** or a **capital investment** added to the cost basis of the property involved.

Legal fees fall into four federal tax reporting categories:

- personal expenses;
- business expenses;
- real estate rental (passive) expenses; or
- investment portfolio expenses.

Legal fees incurred for consultation on a broker's business-related matter are fully deductible as an expense of earning brokerage fees, his trade for which he holds a broker's license.

Legal fees incurred in the management, conservation or maintenance of income-producing real estate — rentals — or for the production or collection of rents, are **deductible** from rental income, a passive income category activity, as an expense. [Internal Revenue Code §212]

However, legal fees incurred in connection with zoning battles, title defenses, condemnation or acquisition must be *capitalized*, not expended. These expenditures are added to the property's basis as they are considered **capital expenditures**, not operating costs. [**Soelling** v. **Commissioner** 70 TC 1052]

Legal expenses incurred to preserve ownership or defend title to an owner's personal residence are **non-deductible** personal expenses.

When employing an attorney, it is prudent for the broker to ask for his advice on the tax deductibility of his fees and, in contingency cases, the reporting of the attorney's share of any recovery.

### Itemized billings

The broker should ask for and review a typical or prototypical billing statement used by the attorney.

The billing statement should be itemized, describing each legal activity or service provided by the attorney or his staff, the date the service was performed, the time spent rendering the service and the fee charged or the cost of each item.

The statement should also state the amount due and the hourly rate or other basis for calculating the fees. [Bus & P C §6148(b)]

Should the broker request a billing at any time, the attorney must provide one within ten days following the request. [Bus & P C §6148(b)]

The broker is entitled to receive invoices at intervals of no less than 30 days following his initial request for a billing statement. [Bus & P C §6148(b)]

The attorney's failure to meet these requirements will render the fee agreement voidable at the option of the broker. However, if the broker elects to void the retainer agreement, the attorney will be entitled to collect a reasonable fee. [Bus & P C §6148(c)]

## Other factors influencing selection

Additional factors the broker should consider before selecting an attorney to represent him include:

- the attorney's familiarity with real estate law and how up to date he is on any statutory, case law and regulatory changes;
- if the attorney will review the file on a monthly or other periodic basis;
- if the attorney will automatically provide the broker with copies of all correspondence, documents and papers related to the case, and at what cost;
- if the attorney will consult with the broker on any substantial issues which may arise before he makes a decision or takes action; and
- if the attorney will review insurance policies (i.e., homeowner's policies, business insurance, errors and omissions insurance) to determine if legal fees are covered.

If the dispute is covered by insurance, the insurance carrier may reserve its right to choose the broker's attorney. However, in some circumstances involving the insurance company's issuance of a reservation of rights, the broker is allowed to select his own attorney in addition to the attorney selected by the insurance carrier.

# Appendix A

*The following represents sections of the Commissioner's Ethics and Professional Conduct Code and the Fair Employment and Housing Acts prohibiting discrimination in housing and real estate brokerage.*

## DRE — Anti-discrimination statutes

### DRE Regulation 2780
### Discriminatory Conduct as the Basis for Disciplinary Action

Prohibited discriminatory conduct by a real estate licensee based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin includes, but is not limited to, the following:

(a) Refusing to neotiate for the sale, rental or financing of the purchase of real property or otherwise making unavailable or denying real property to any person because of such person's race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(b) Refusing or failing to show, rent, sell or finance the purchase of real property to any person or refusing or failing to provide or volunteer information to any person about real property, or channeling or steering any person away from real property, because of that person's race, color, sex, religion, ancestry, physical handicap, marital status or national origin or because of the racial, religious, or ethnic composition of any occupants of the area in which the real property is located.

(c) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in the sale or purchase or negotiation or solicitation of the sale or purchase or the collection of payment or the performance of services in connection with contracts for the sale of real property or in connection with loans secured directly or collaterally by liens on real property or on a business opportunity.

(d) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in the terms, conditions or privileges of sale, rental or financing of the purchase of real property.

(e) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in providing services or facilities in connection with the sale, rental or financing of the purchase of real property, including but not limited to: processing applications differently, referring prospects to other licensees because of the prospects' race, color, sex, religion, ancestry, physical handicap, marital status or national origin, using with discriminatory intent or effect, codes or other means of identifying minority prospects, or assigning real estate licensees on the basis of a prospective client's race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(f) Representing to any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin that real property is not available for inspection, sale or rental when such real property is in fact available.

(g) Processing an application more slowly or otherwise acting to delay, hinder or avoid the sale, rental or financing of the purchase of real property on account of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of a potential owner or occupant.

(h) Making any effort to encourage discrimination against persons because of their race, color, sex, religion, ancestry, physical handicap, marital status or national origin in the showing, sale, lease or financing of the purchase of real property.

(i) Refusing or failing to cooperate with or refusing or failing to assist another real estate licensee in negotiating the sale, rental or financing of the purchase of real property because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of any prospective purchaser or tenant.

(j) Making any effort to obstruct, retard or discourage the purchase, lease or financing of the purchase of real property by persons whose race, color, sex, religion, ancestry, physical handicap, marital status or national origin differs from that of the majority of persons presently residing in a structural improvement to real property or in an area in which the real property is located.

(k) Performing any acts, making any notation, asking any questions or making or circulating any written or oral statement which when taken in context, expresses or implies a limitation, preference or discrimination based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin; provided, however, that nothing herein shall limit the administering of forms or the making of a notation required by a federal, state or local agency for data collection or civil rights enforcement purposes; or in the case of a physically handicapped person, making notation, asking questions or circulating any written or oral statement in order to serve the needs of such a person.

(l) Making any effort to coerce, intimidate, threaten or interfere with any person in the exercise or enjoyment of, or on account of, such person's having exercised or enjoyed, or on account of such person's having aided or encouraged any other person in the exercise or enjoyment of any right granted or protected by a federal or state law, including but not limited to: assisting in any effort to coerce any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin to move from, or to not move into, a particular area; punishing or penalizing real estate licensees for their refusal to discriminate in the sale or rental of housing because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of a prospective purchaser or lessee; or evicting or taking other retaliatory action against any person for having filed a fair housing complaint or for having undertaken other lawful efforts to promote fair housing.

(m) Soliciting of sales, rentals or listings of real estate from any person, but not from another person within the same area because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons.

(n) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin in informing persons of the existence of waiting lists or other procedures with respect to the future availability of real property for purchase or lease.

(o) Making any effort to discourage or prevent the rental, sale or financing of the purchase of real property because of the presence or absence of occupants of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin, or on the basis of the future presence

or absence of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin, whether actual, alleged or implied.

(p) Making any effort to discourage or prevent any person from renting, purchasing or financing the purchase of real property through any representations of actual or alleged community opposition based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(q) Providing information or advice to any person concerning the desirability of particular real property or a particular residential area(s) which is different from information or advice given to any other person with respect to the same property or area because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons.

(r) Refusing to accept a rental or sales listing or application for financing of the purchase of real property because of the owner's race, color, sex, religion, ancestry, physical handicap, marital status or national origin or because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of any of the occupants in the area in which the real property is located.

(s) Entering into an agreement, or carrying out any instructions of another, explicit or understood, not to show, lease, sell or finance the purchase of real property because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(t) Making, printing or publishing, or causing to be made, printed or published, any notice, statement or advertisement concerning the sale, rental or financing of the purchase of real property that indicates any preference, limitation or discrimination because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin, or any intention to make such preference, limitation or discrimination.

(u) Using any word, phrases, sentences, descriptions or visual aids in any notice, statement or advertisement describing real property or the area in which real property is located which indicates any preference, limitation or discrimination because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(v) Selectively using, placing or designing any notice, statement or advertisement having to do with the sale, rental or financing of the purchase of real property in such a manner as to cause or increase discrimination by restricting or enhancing the exposure or appeal to persons of a particular race, color, sex, ancestry, physical handicap, marital status or national origin. This subdivision does not limit in any way the use of an affirmative marketing program designed to attract persons of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin who would not otherwise be attracted to the real property or to the area.

(w) Quoting or charging a price, rent or cleaning or security deposit for a particular real property to any person which is different from the price, rent or security deposit quoted or charged to any other person because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons.

(x) Discriminating against any person because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin in performing any acts in connection with the making of any determination of financial ability or in the processing of any application for the financing or refinancing of real property.

(y) Advising a person of the price or value of real property on the basis of factors related to the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of residents of an area or of residents or potential residents of the area in which the property is located.

(z) Discriminating in the treatment of, or services provided to, occupants of any real property in the course of providing management services for the real property because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of said occupants.

(aa) Discriminating against the owners or occupants of real property because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of their guests, visitors or invitees.

(bb) Making any effort to instruct or encourage, expressly or impliedly, by either words or acts, licensees or their employees or other agents to engage in any discriminatory act in violation of a federal or state fair housing law.

(cc) Establishing or implementing rules that have the effect of limiting the opportunity for any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin to secure real property through a multiple listing or other real estate service.

(aa) Assisting or aiding in any way, any person in the sale, rental or financing of the purchase of real property where there are reasonable grounds to believe that such person intends to discriminate because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

**Calif. Business and Professions Code §125.6**
**Refusal to perform licensed activity**

Every person who holds a license under the provisions of this code is subject to disciplinary action under the disciplinary provisions of this code applicable to such person if, because of the applicant's race, color, sex, religion, ancestry, disability, marital status, or national origin, he or she refuses to perform the licensed activity or aids or incites the refusal to perform such licensed activity by another licensee, or if, because of the applicant's race, color, sex, religion, ancestry, disability, marital status, or national origin, he or she makes any discrimination, or restriction in the performance of the licensed activity.

Nothing in this section requires a person licensed pursuant to Division 2 (commencing with Section 500) to permit an individual to participate in, or benefit from, the licensed activity of the licensee where that individual poses a direct threat to the health or safety of others. For this purpose, the term "direct threat" means a significant risk to the health or safety of others that cannot be eliminated by a modification of policies, practices, or procedures or by the provision of auxiliary aids and services.

"Disability" means any of the following with respect to an individual:

(a) A physical or mental impairment that substantially limits one or more of the major life activities of the individual.

(b) A record of such an impairment.

(c) Being regarded as having such an impairment.

## Calif. Business and Professions Code §10177
## Grounds for suspension or revocation of a real estate license

The commissioner may suspend or revoke the license of any real estate licensee, or may deny the issuance of a license to an applicant, who has done any of the following:

(1) Solicited or induced the sale, lease or the listing for sale or lease, of residential property on the ground, wholly or in part, of loss of value, increase in crime, or decline of the quality of the schools, due to the present or prospective entry into the neighborhood of a person or persons of another race, color, religion, ancestry or national origin.

## Calif. Civil Code §51
## Unruh Civil Rights Act

All persons within the jurisdiction of this state are free and equal, and no matter what their sex, race, color, religion, ancestry, national origin, or disability are entitled to the full and equal accommodations, advantages, facilities, privileges, or services in all business establishments of every kind whatsoever.

A violation of the right of any individual under the Americans with Disabilities Act of 1990 (Public Law 101-336) shall also constitute a violation of this section.

## Calif. Civil Code §54.1
## Unlawful discrimination due to physical disability

(b)(1) Individuals with disabilities shall be entitled to full and equal access, as other members of the general public, to all housing accommodations offer for rent, lease, or compensation in this state subject to the conditions and limitations established by law, or state or federal regulation, and applicable alike to all persons.

(6)(A) It shall be deemed a denial of equal access to housing accommodations within the meaning of this subdivision for any person, firm, or corporation to refuse to lease or rent housing accommodations to an individual who is blind or visually impaired on the basis that the individual uses the services of a guide dog, an individual who is deaf or hearing impaired on the basis that the individual uses the services of a signal dog, or to an individual with any other disability on the basis that the individual uses the services of a service dog, or to refuse to permit such an individual who is blind or visually impaired to keep a guide dog, an individual who is deaf or hearing impaired to keep a signal dog, or an individual with any other disability to keep a service dog on the premises.

## Calif. Government Code §12940
## Unlawful employment practices

It shall be an unlawful employment practice, unless based upon a bona fide occupational qualification, or, except where based upon applicable security regulations established by the United States or the State of California:

(g) For an employer, because of the race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, or sex of any person, to refuse to hire or employ the person or to refuse to select the person for a training program leading to employment, or to bar or to discharge the person from employment or from a training program leading to employment,

or to discriminate against the person in compensation or in terms, conditions or privileges of employment.

(c) For any person to discriminate against any person in the selection or training of that person in any apprenticeship training program or any other training program leading to employment because of the race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, or sex of the person discriminated against.

(d) For any employer or employment agency, unless specifically acting in accordance with federal equal employment opportunity guidelines and regulations approved by the commission, to print or circulate or cause to be printed or circulated any publication, or to make any non-job-related inquiry, either verbal or through use of an application form, which expresses, directly or indirectly, any limitation, specification, or discrimination as to race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, or sex, or any intent to make that limitation, specification or discrimination.

(f) For any employer, labor organization, employment agency, or person to discharge, expel, or otherwise discriminate against any person because the person has opposed any practices forbidden under this part or because the person has filed a complaint, testified, or assisted in any proceeding under this part.

(h) For an employer, labor organization, employment agency, apprenticeship training program or any training program leading to employment, or any other person, because of race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, sex, or age, to harass an employee or applicant.

## Calif. Government Code §12941

(i) It is an unlawful employment practice for an employer to refuse to hire or employ, or to discharge, dismiss, reduce, suspend, or demote, any individual over the age of 40 on the ground of age, except in cases where the law compels or provides for such action.

## Calif. Government Code §12955
## Housing discrimination

It shall be unlawful:

(j) For the owner of any housing accommodation to discriminate against any person because of the race, color, religion, sex, marital status, national origin, or ancestry of such person.

(k) For the owner of any housing accommodation to make or to cause to be made any written or oral inquiry concerning the race, color, religion, sex, marital status, national origin, or ancestry of any person seeking to purchase, rent or lease any housing accommodation.

(f) For any owner of housing accommodations to harass, evict, or otherwise discriminate against any person in the sale or rental of housing accommodations when the owner's dominant purpose is retaliation against a person who has opposed practices unlawful under this section, informed law enforcement agencies of practices believed unlawful under this section, or has testified or assisted in any proceeding under this part.

(l) To discriminate through public or private land use practices, decisions, and authorizations because of race, color, religion, sex, familial status, marital status, disability, national origin, or ancestry.

Discrimination includes, but is not limited to, restrictive covenants, zoning laws, denials of use permits, and other actions authorized under the Planning and Zoning Law (Title 7 (commencing with Section 65000)), that make housing opportunities unavailable.

### Calif. Health and Safety Code §35810
### Unlawful discrimination by lenders

(m) No financial institution shall discriminate in the availability of, or in the provision of, financial assistance for the purpose of purchasing, constructing, rehabilitating, improving, or refinancing housing accommodations due, in whole or in part, to the consideration of conditions, characteristics, or trends in the neighborhood or geographic area surrounding the housing accommodation, unless the financial institution can demonstrate that consideration of these conditions in the particular case is required to avoid an unsafe and unsound business practice.

(n) Nothing in this section shall be construed to prohibit any financial institution from establishing a special loan program designed to engender equality in housing in accordance with the federal Fair Housing Act (42 U.S.C. Secs. 3601 et seq.) or similar state and federal laws, so long as the program promotes housing opportunities in ethnic minority or low-income neighborhoods.

### Calif. Health and Safety Code §35811

No financial institution shall discriminate in the availability of, or in the provision of, financial assistance for the purpose of purchasing, constructing, rehabilitating, improving or refinancing housing accommodations due, in whole or in part, to the consideration of race, color, religion, sex, marital status, national origin, or ancestry.

### Calif. Health and Safety Code §35812

No financial institution shall consider the racial, ethnic, religious, or national origin composition of a neighborhood or geographic area surrounding a housing accommodation or whether or not such composition is undergoing change, or is expected to undergo change, in appraising a housing accommodation or in determining whether or not, and under what terms and conditions, to provide financial assistance for the purpose of purchasing, constructing, rehabilitating, improving, or refinancing a housing accommodation. No financial institution shall utilize appraisal practices that are inconsistent with the provisions of this part.